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82-1980

No. ....
IN THE

# Supreme Court of the United States

October Term, 1982

HELEN SMITH,

*Petitioner,*

*vs.*

FRED H. HARMSEN, *et al.*,

*Respondents.*

**Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.**

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## Questions Presented for Review.

Petitioner Helen Smith respectfully seeks review of the following questions, which arise out of a federal class action imposing multi-million dollar liability upon her for secondary violation of federal securities laws and related pendent claims:

1. Whether under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 (17 CFR § 240.10b-5) civil liability may be imposed under an aiding and abetting theory, *i.e.*, a non-statutory, "add-on" theory of secondary liability derived from common law.[1] This Court has explicitly reserved this issue for decision.

2. Assuming that "add-on" theories of secondary liability are permitted under § 10(b) and Rule 10b-5, whether *secondary* civil liability may be imposed without proof of the requisite elements of a cause of action for *primary* civil liability under § 10(b) and Rule 10b-5, specifically where:

a. Petitioner lacked any connection with the purchase or sale of securities, she had no independent duty of disclosure, and her secondary liability was predicated solely on her inaction in the face of the primary defendant's alleged nondisclosure of material facts to the market at large;

b. Petitioner's alleged failure to disclose material facts was not accompanied by scienter (*i.e.*, intent to deceive, manipulate or defraud); and

c. There was no proof of any causal connection between Petitioner's silence and any damage to plaintiffs.

3. Whether named plaintiffs have standing to assert any violation of § 10(b) and Rule 10b-5 against Petitioner where they acquired securities prior to any alleged secondary violation by her.

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[1]This question similarly embraces other non-statutory common law theories of secondary liability.

4. Whether Petitioner has been denied due process of law by being required to defend a federal class action suit where:

a. A nationwide class of shareholders was certified to pursue claims under the National Bank Act, but there was no claim against Petitioner under the National Bank Act;

b. The only federal causes of action against Petitioner asserted claims of secondary liability under § 10(b) and Rule 10b-5, but no class or subclass of purchasers or sellers of securities was ever certified under Rule 23, Federal Rules of Civil Procedure, and the named plaintiffs lacked any individual cause of action against Petitioner under § 10(b) and Rule 10b-5; and

c. The district court excluded Petitioner's proffered expert testimony demonstrating the non-materiality of any nondisclosure relating to her thus denying her the opportunity to negate any possible inference of a "fraud on the market."

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No. .....

IN THE

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October Term, 1982

HELEN SMITH,

*Petitioner,*

*vs.*

FRED H. HARMSEN, *et al.*,

*Respondents.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

### Petition[2]

Petitioner, Helen Smith, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on December 1, 1982.

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[2]Parties to the proceedings below: Named plaintiffs in the underlying action were Fred H. Harmsen, Ken Hansen, Samuel Rosenberg and James P. Young, suing individually and on behalf of a class certified (to pursue alleged violations of the National Bank Act) as including "all persons and entities, excluding the defendant shareholders, who were beneficial owners of United States National Bank common stock on October 18, 1973. . . ." (CR 246.)

By a single opinion, the Court of Appeals decided the several appeals arising out of the lower court judgment: No. 80-5097 brought by Petitioner herein; No. 80-5098 brought by C. Arnholt Smith, Carol Smith Shannon and Philip A. Toft; and No. 80-5099 brought by John A. Smith and First National Finance Corporation.

Several other defendants were not represented at trial and/or defaulted prior to trial; thus judgment was entered against a number of other parties who took no appeals; these were: M. J. Coen, U.S. Holding Company, San Diego Padres and First California Company. (CR 1081, 1103.)

## Opinions Below.

The Opinion of the Court of Appeals is published at 693 F.2d 932, and is reproduced in the Appendix hereto at pages 1-28.

## Jurisdiction.

The judgment sought to be reviewed was filed and entered on December 1, 1982. Petitioner's petition for rehearing was denied and her suggestion for rehearing en banc rejected on March 3, 1983. Petitioner's motion for stay of mandate pending application for writ of certiorari was granted on March 17, 1983 and issuance of the mandate was thereby stayed until June 1, 1983, and, upon the filing of the within Petition, until disposition by this Court. This Court has jurisdiction under 28 U.S.C. § 1254(1).

## Constitutional Provisions, Statutes and Regulations Involved.

The following constitutional provisions, statutes and rules are involved in this case and set forth in the Appendix hereto at pages 35-39:

1. Securities Exchange Act of 1934, Sec. 10(b) (15 U.S.C. § 78j(b))
2. Securities and Exchange Commission Rule 10b-5 (17 C.F.R. § 240.10b-5)
3. Securities Exchange Act of 1934, § 20(a) (15 U.S.C. § 78t(a))
4. Securities Exchange Act of 1934, § 28(a) (15 U.S.C. § 78bb(a))
5. Due Process Clause of the Fifth Amendment to the United States Constitution
6. Rule 23, Federal Rules of Civil Procedure.

## Statement of the Case.

### 1. Jurisdiction in the Court of First Instance.

Jurisdiction and venue of the District Court for the Southern District of California were invoked under 12 U.S.C. § 94 and 28 U.S.C. §§ 1331 and 1337 with respect to alleged violations of the National Bank Act, under 15 U.S.C. § 78aa with respect to alleged violations of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 enacted thereunder,[3] and under the District Court's pendent jurisdiction with respect to certain state law claims.

### 2. Summary of Underlying Facts.

In October 1973, the Comptroller of the Currency declared United States National Bank of San Diego ("USNB") insolvent, and the bank was placed in receivership. C. Arnholt Smith headed and was majority shareholder of USNB. Petitioner Helen Smith, an independently wealthy woman, had married Mr. Smith in July of 1968.

Among the uncontradicted facts are: Petitioner was never an officer, director or employee of USNB; she did not attend meetings of the bank directors or any of its committees (CR 1036, p. 18; RT 7060 [stipulated facts]); she was not an attorney, accountant, consultant or otherwise involved in USNB's financial affairs, nor could she have been involved in the preparation or dissemination of annual reports, proxy statements, letters to shareholders or other documents issued

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[3]The pretrial order of the District Court erroneously cites 15 U.S.C. § 77v(a) as governing jurisdiction and venue for purposes of alleged violations of the Securities Exchange Act of 1934 and Rule 10b-5 (CR 1036, p. 18), whereas the correct statutory provision is 15 U.S.C. § 78aa. To be precise, it should be noted that the jurisdiction of the District Court was originally premised upon alleged violations of the National Bank Act. Following certification of the plaintiff class, however, plaintiffs (respondents herein) amended their complaint to allege violations of the Securities Exchange Act of 1934, thereby invoking the District Court's jurisdiction under 15 U.S.C. § 78aa. (App., p. 14.)

by USNB. (See, *e.g.*, RT 2092, 2544-45, 2928, 2946-49, 3638, 4525, 5166-68, 5189-90.)

Petitioner's limited relations with USNB were as follows: she was a depositor of USNB and from time to time owned relatively small amounts of USNB stock. She had three loans from USNB, two fully secured conventional loans and one unsecured business loan, each under prevailing terms and interest rates.[4] Beginning in 1969 she performed certain interior decorating services for the bank. (CR 1036, p. 19.)

At all relevant times, USNB's annual reports and other public disclosures were prepared by legal and accounting personnel and bank officials pursuant to standards promulgated by the Comptroller of the Currency. (See, *e.g.*, RT 3463, 3468, 3562-63, 5168-69, 5202-18, 5228.) Petitioner's services for the bank and her unsecured business loan were properly reflected in USNB's books and specifically referenced in USNB's proxy statements for 1972 and 1973. (See, *e.g.*, Pl. Exh. 94; HS Exh. 73; RT 2373-88, RT 7060-61 [stipulated facts].[5] When the FDIC became USNB's receiver, it reviewed and approved all of Petitioner's trans-

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[4]On December 30, 1970, Petitioner, whose deposits with USNB (including certificates of deposit) then exceeded $1,000,000, obtained a $500,000 one-year business loan; interest of $47,000 was prepaid then, as it was when the loan was subsequently renewed at a reduced level. (*E.g.*, RT 2331-36, 2366-74, 2377-81; Pl. Exh. 416-A, HS Exh. 56.) Because Petitioner prepaid interest on her unsecured loan, some USNB documents reflected "zero interest." Plaintiffs transformed this, in argument, into "no interest loans," despite the uncontradicted testimony of the representative of the FDIC that USNB's records were "a little deceptive because it would appear that Mrs. Smith is not paying interest, where, in fact, she had paid interest." (RT 2373; see HS Exh. 56.)

In November 1971 and July 1972, Petitioner obtained fully secured real estate loans on real property investments for, respectively, $84,000 and $137,000. (CR 1036, pp. 19-20; RT 7061 [stipulated facts].)

[5]The bank's annual reports for these years reported extensions of credit to directors, officers, principal shareholders and their associates exceeding $35,000,000. (Pl. Exh. 94, HS Exh. 73.)

actions with the bank. None of Petitioner's loans or other transactions with USNB had ever been criticized by bank examiners. (RT 2257-59, 2351-52; Pl. Exhs. 169, 170.)

**3. Procedural History.**

Shortly after USNB was placed in receivership, two separate class action suits were filed. These two suits primarily alleged violations of the National Bank Act by C. Arnholt Smith and other officials of USNB. They were consolidated. A class was certified of all beneficial owners of USNB stock at the time it was closed (excluding defendants). (CR 246.) On a prior interlocutory appeal by the Federal Deposit Insurance Corporation ("FDIC"), USNB's receiver, the Ninth Circuit Court of Appeals (Judge Hufstedler, dissenting) permitted the action to proceed, with limitations, rejecting the contention that only the FDIC could pursue on behalf of the bank the claims asserted individually by plaintiffs. See *Harmsen v. Smith*, 542 F.2d 496 (9th Cir. 1976).

Thereafter, the complaint was amended to include § 10(b) and Rule 10b-5 causes of action, C. Arnholt Smith being the alleged primary violator, Petitioner and others being charged with aiding and abetting and other theories of secondary liability. Petitioner was granted summary judgment on the National Bank Act claims (CR 1040); therefore, the allegations under § 10(b) and Rule 10b-5 were the sole basis of federal jurisdiction regarding her.

By the time of trial, C. Arnholt Smith was the only remaining defendant charged with violations of the National Bank Act. Nevertheless, the action proceeded under the original class certification under the National Bank Act (*owners* of USNB shares), including pendent California claims seeking punitive damages, this despite protestations by Petitioner and other defendants that (a) there was not a proper class of plaintiffs as to them (*purchasers* and *sellers*

of USNB shares), and (b) no named plaintiff had standing to sue her because all of them had acquired their USNB stock prior to the earliest alleged primary § 10(b) violation allegedly linked to Petitioner.

The trial was bifurcated. Neither of the two named plaintiffs who testified asserted any individual grievance against Petitioner, nor did any other member of the class of shareholders (much less a representative of purchasers) do so. (CR 551, 556, 566, 588, 1017, 1040.)

The action against Petitioner was ostensibly premised on allegations she had, by her silence, assisted a "fraud on the market" perpetrated by nondisclosure of material facts in USNB's public reports regarding her transactions with USNB.[6] Petitioner's dealings with USNB, however, even had they somehow been improper (which they were not), to the extent they were not specifically disclosed by USNB, would not have been material to the average investor according to plaintiffs' own evidence. (RT 9181-83.)[7] Moreover, the district court itself warned plaintiffs' counsel at the close of the liability phase of plaintiffs' case that there was no evidence Petitioner had any knowledge of any alleged nondisclosure regarding her transactions with USNB. (RT 6185-86.)

Legal limitations on plaintiffs' suit under the National Bank Act, the exclusive authority of the FDIC to pursue claims on behalf of USNB, and the requirements of § 10(b) and Rule 10b-5 were ultimately lost in the trial proceedings.

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[6]The jury was instructed solely on an "omissions" theory of primary § 10(b) liability. (See RT 6062-63, 6312.)

[7]The district court prohibited Petitioner's expert from testifying that, based on his study of actual behavior of the stock market involving USNB stock, any alleged nondisclosure regarding Petitioner's relations with USNB would not have significantly altered the total mix of information available to the average reasonable investor, *i.e.*, it was not material. (RT 5832-35, 5883-85.)

At the end, plaintiffs' counsel urged the jury to act on a "gut level" feeling that "something wrong was done here . . . [w]hatever you want to call it, aiding and abetting, conspiracy, controlling person." (RT 6608.) According to plaintiffs' counsel, " '[I]t's when you put the last drop in that the cup overflows.' Ladies and Gentlemen, what is the last drop here? Are we going to say it was J. A. Smith? Are we going to say it was Mrs. Smith? What was it? Who really caused the Bank to fail?" (RT 6572.)

In the first phase of the proceedings, the jury found Petitioner liable on secondary theories of aiding and abetting, conspiracy and controlling person and several related state counts. (CR 1081.) In the damages phase, it fixed her liability at over $6,200,000 based on the estimated value of *all* USNB stock which was transferred or issued on or after March 1, 1971, plus $750,000 in punitive damages on the state law counts. (CR 1103.)

**4. The Court of Appeals Opinion.**

The Court of Appeals deemed it necessary to consider only a single basis of secondary liability under § 10(b) and Rule 10b-5, *i.e.*, aiding and abetting. The Court duly noted Petitioner's contention that such liability does not exist, further noted the doubt and criticism levelled at such "add-on" theories of liability, and noted that this Court's most recent holdings suggest that the statutory scheme provides the sole source of civil liability and should not be embellished by common law theories of liability. The Court of Appeals virtually invited this Court's review, holding that there is such liability because "the Supreme Court has not yet seen fit to follow that suggestion." (App., p. 20.)

The Court of Appeals proceeded to affirm such liability on the part of Petitioner without regard to the requisites for civil liability established by this Court's holdings. To the

contrary, the Court of Appeals expressly repudiated the contention that no liability could be imposed absent a duty to disclose as held in *Chiarella v. United States*, 445 U.S. 222 (1980).[8] The Court of Appeals, having found it unnecessary to identify any duty by Petitioner to disclose apart from one premised merely on her knowledge of her own relations with USNB, similarly found it unnecessary to identify (a) any material nondisclosure of facts by Petitioner or assisted by her, (b) any conduct by Petitioner in connection with the purchase or sale of securities, (c) any intent by Petitioner to deceive, manipulate or defraud, or (d) any damages caused by any nondisclosures which Petitioner allegedly assisted by her omission to make public announcement of her transactions with USNB.

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[8]Despite Petitioner's repeated insistence that no such duty existed (see, *e.g.*, AOB 46-47, ARB 22-23), the opinion of the Court of Appeals addresses the issue only with respect to appellants Shannon and Toft. (App., pp. 20-21.)

## REASONS FOR GRANTING REVIEW.

### 1. THIS COURT SHOULD NOW ADDRESS THE FUNDAMENTALLY IMPORTANT ISSUE IT HAS EXPLICITLY RESERVED, NAMELY, WHETHER CIVIL LIABILITY UNDER § 10(b) AND RULE 10b-5 MAY BE IMPOSED ON THE BASIS OF THE COMMON LAW THEORY OF AIDING AND ABETTING.

If, for historical reasons, it is now too late for this Court to consider whether any private right of action is implied under § 10(b), now is precisely the time to address an equally important issue this Court has explicitly reserved, namely, "whether civil liability for aiding and abetting is appropriate under the section and the Rule." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-192, n. 7 (1976); see also *Herman & MacLean v. Huddleston*, ___ U.S. ___, 74 L.Ed.2d 548, 553, n. 5 (1983) ["While several courts of appeals have permitted aider and abettor liability . . . we specifically reserved this issue in *Ernst & Ernst v. Hochfelder*"]. In this case, the issue is squarely presented and is dispositive. This case dramatically illustrates the potential for add-on theories of secondary liability to swallow this Court's painstaking articulation of the rationale and scope of civil liability under § 10(b) and Rule 10b-5.

This Court has repeatedly stressed that the issue of liability under § 10(b) and Rule 10b-5 must be determined by relevant statutory language, legislative history and the statutory structure of the securities laws, not by court-created notions of public policy. *E.g., Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979). As a result, numerous courts (including another panel of the Ninth Circuit Court of Appeals) and commentators have suggested or opined that aiding and abetting and other common law theories of

secondary liability have no place under § 10(b) and Rule 10b-5.[9]

The Court of Appeals in the instant case abjured the analysis mandated by this Court's decisions, expressly leaving it to this Court, stating (App., p. 20): "[T]he Supreme Court has not yet seen fit to follow that suggestion. . . . In the absence of any authority or compelling reasons for holding that aider and abettor liability no longer exists, we hold that it remains a viable part of securities regulation." Thereby, the Court of Appeals held, for the first time since this Court noted this as an open question, that aiding and abetting is a viable basis for civil liability under § 10(b) and Rule 10b-5 simply because it has been previously assumed to exist. Thus, yet again, a new branch of civil liability, of potentially much vaster scope than the "judicial oak" from

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[9]See, *e.g.*, Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal.L.Rev. 80 (1981); *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1311, n. 12 (9th Cir. 1982) ["Aiding and abetting and other 'add-on' theories of liability have been justified by reference to the broad policy objectives of the securities acts. . . . (¶) The Supreme Court has rejected this justification for an expansive reading of the statutes and instead prescribed a strict statutory construction approach to determining liability under the acts. . . . (¶) (Professor Fischel) argues in fact that *Ernst & Ernst v. Hochfelder*, *supra*, implicitly holds that aiding and abetting liability does not exist as an area of liability distinct from liability that could be imposed for a direct violation of the section and rule"]; *Admiralty Fund v. Tabor*, 677 F.2d 1297, 1299, n. 2 (9th Cir. 1982) [noting, "the status of implied secondary liability under the securities laws is in doubt"]; *Admiralty Fund v. Jones*, 677 F.2d 1289, 1294-1295, n. 4 (9th Cir. 1982) ["We note the doubtful nature of both (aider and abettor and the participant theory relied upon in *SEC v. Murphy*, 626 F.2d 633 (9th Cir. 1980)) in light of recent Supreme Court cases that prescribe a strict statutory construction approach to the securities acts and reject their expansion with tort and criminal theories"]; *Benoay v. Decker*, 517 F.Supp. 490, 495 (E.D.Mich. 1981) ["it is . . . doubtful that a claim for 'aiding and abetting' or 'conspiracy' will continue to exist under 10(b)"]; *In re Gap Stores Securities Litigation*, 457 F.Supp. 1135, 1144 (N.D.Cal. 1978) ["Recent decisions . . . raise questions about the continued utility of aiding or abetting as a separate theory of liability"]. And *cf.*, *Christoffel v. E. F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975) [rejecting respondeat superior as common law basis for liability under § 10(b)].

which it springs, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975), has found judicial endorsement wholly outside, indeed despite, the statutory scheme. If past experience is any guide, what is now the law of the Ninth Circuit will by process of accretion soon be the law of every circuit, repeating a familiar pattern of unanalyzed expansion of the securities laws well beyond any foundation in the statutory language, history or intent. The Court of Appeals has effectively invited, one might say challenged, this Court's review. Petitioner respectfully urges this Court to accept.

**2. BY EXPANDING SECONDARY LIABILITY BEYOND ANY PRIOR BOUNDS, THE COURT OF APPEALS HAS EFFECTIVELY ELIMINATED PROOF OF THE REQUISITE ELEMENTS OF CIVIL LIABILITY UNDER § 10(b) AND RULE 10b-5 AS PREVIOUSLY ESTABLISHED BY THIS COURT, THUS OPENING VAST NEW VISTAS OF CIVIL LIABILITY FOR ANYONE EVEN REMOTELY CONNECTED, NOT WITH A SECURITIES LAW VIOLATION, BUT WITH A SECURITIES LAW VIOLATOR.**

Even assuming that common law theories of secondary liability can be tacked onto § 10(b) and Rule 10b-5, the Court of Appeals' interpretation of the extent of such liability is in direct conflict with the decisions of this and other Courts establishing the requisite foundations for liability under the section and the Rule.[10] This Court has explicitly held that liability under § 10(b) and Rule 10b-5 for a failure to disclose requires (a) "a duty to disclose," *Chiarella v. United States, supra*, 445 U.S. 222, 230, "in connection with the purchase or sale" of securities, *Blue Chip Stamps v. Manor Drug Stores, supra*, 421 U.S. 723; (b) breach of

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[10]Having reserved the fundamental issue, this Court has not yet considered the elements which might be necessary to establish any such secondary liability. *Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 191-192, n. 7.

this duty with the intent "to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 193; (c) causing actual and identifiable damages, see *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154-155 (1972).

The opinion of the Court of Appeals makes secondary liability for aiding and abetting coextensive with primary liability, yet effectively eliminates each of the requisite elements of primary liability.

**a. No Secondary Liability for Nondisclosure Should Exist Absent a Duty to Make Disclosure. No Such Duty Can Be Predicated Solely on Knowledge of Another's Breach of Duty, nor Merely on a Marital or Other Relationship With Such a Person.**

Under the Court of Appeals' decision, silence with knowledge (actual or imputed) of another person's nondisclosure in violation of § 10(b) and Rule 10b-5 is, given some connection with the *violator*, sufficient without more to impose the same liability as for a primary violation. Hence, according to the opinion, for a secondary defendant to invoke the duty requirement of *Chiarella* "blurs the distinction between primary and secondary violations of section 10(b)." (App., p. 20.)

In *Chiarella* this Court held that silence does not give rise to liability for a failure to disclose material non-public information absent a duty to disclose "arising from a relationship of trust and confidence . . . ." (445 U.S. at 230.) The Court of Appeals in this case, however, effectively discards *any* duty requirement for a secondary violation by holding that a secondary violator's duty arises, and is therefore simultaneously breached, by knowing assistance of or participation in a fraudulent scheme, *i.e.*, silence with knowledge of *another's* breach of *his* duty. Obviously, any

time anyone learns of someone else's violation of the securities laws he must also know that a failure to speak, to publicize his knowledge, will assist the primary violator's success; silence with knowledge thus necessarily translates into "knowingly provid[ing] substantial assistance in the fraud" by failure to blow the whistle. (App., p. 19.)

In the Court of Appeals' formulation, the only "in connection with" required is a connection with an alleged primary violator, not with the purchase or sale of securities. Indeed, the opinion describes the duty breached by the primary violator, C. Arnholt Smith, as one owed to the bank's *shareholders*, without regard to any purchase or sale of bank stock. (App., p. 20.)[11] Thus, a secondary violator's duty is virtually limitless, arising solely from a connection with a violator and silence with knowledge of the primary violator's conduct. This extraordinary expansion of liability sweeps in not only C. Arnholt Smith's wife (and other family members), but would equally reach attorneys, banks and other financial institutions, indeed anyone who may have a connection with a securities law violator, even though they have no connection with any securities transaction.[12] Even assuming Petitioner had some reason to believe "that potential investors were being deceived by C. Arnholt" (App., p. 19) (there is *no* evidence to that effect), what duty did Petitioner have to potential investors when she had no

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[11]Mr. Smith was at all times the bank's majority shareholder. The class of shareholders was not purchasing from him, but in the relatively thin market for USNB stock.

[12]This is consistent with the argument of plaintiffs' counsel, in opposition to motions for directed verdict and to decertify the class: "The fact that she [Petitioner] didn't disclose anything, the fact that she didn't have an opportunity to disclose anything really means nothing when we are talking about aiding and abetting. [¶] What she is doing is aiding and abetting in the primary act, the primary fraudulent act of violating the law." (RT 5585.)

relationship whatever with them or with the market? And as a practical matter, how could she possibly have fulfilled any such duty?

*Dirks v. S.E.C.*, 681 F.2d 824 (D.C. Cir.), cert. granted 74 L.Ed.2d 506 (1982), where aiding and abetting liability was upheld in a disciplinary action, makes for dramatic comparison with this case. In *Dirks*, a broker-dealer obtained non-market information of the Equity Funding scandal. He tried to interest the *Wall Street Journal* in the story but, failing that, saw that his clients were able to act on his information. In this case, unlike *Dirks*, Petitioner was not a broker-dealer nor did she have any connection with the securities market; she neither did nor stood to profit from any nondisclosure of her transactions; she had no knowledge of any major scandal or any seemingly significant "inside information." Was she supposed to go to the *Wall Street Journal*? And report what — that she had two fully secured conventional loans from USNB, one unsecured business loan, and was paid for decorating services and furnishings — all of which was already generally or specifically disclosed in public documents?[13]

Under the opinion of the Court of Appeals, anyone having relations with a stock issuer has "inside information" regarding his own relations, and the duty attending possession of such "inside information" is not just to "disclose or abstain" but to disclose on pain of liability to all the world should the persons responsible for appropriate disclosures fail to make them. But, see, *e.g.*, *General Time Corporation*

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[13]Contrary to the Court of Appeals' opinion (App., p. 19), Petitioner never acquired real property from USNB at all (much less at minimal cost), nor did she receive any loans at "non-market terms." But even if she had, the question remains on what basis any transaction with a corporation translates into a § 10(b) violation if the corporation fails to make appropriate disclosures.

*v. Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), cert. denied 393 U.S. 1026 (1969) [tender offeror does not violate § 10(b) when it makes preannouncement purchases because there is no relationship between the offeror and the seller].

**b. Absent an Independent Duty to Act, Inaction Cannot Give Rise to Liability. Nor Should Secondary Civil Liability to All the World Be Imposed for Failure to "Blow the Whistle" on Another's Nondisclosure, Absent an Intent to Deceive, Manipulate or Defraud.**

If a duty to speak arises from the mere possession of nonmarket information resulting from a connection with a securities law violator, silence with knowledge, mere inaction, becomes the sole test for liability under § 10(b) and Rule 10b-5. *Cf., ITT, An Intern. Inv. Trust v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980) ["(I)naction can create aider and abettor liability only when there is a conscious or reckless violation of an independent duty to act"]. The scienter requirement stated in *Hochfelder* (an aiding and abetting case) *i.e.*, intent to deceive, manipulate or defraud — which in the Courts of Appeals was downgraded to recklessness, see *Herman & MacLean v. Huddleston, supra*, ___ U.S. ___, 74 L.Ed.2d at 553, note 4, — disappears through further dilution under secondary liability to a simple knowledge requirement in some circumstances by equating recklessness with knowledge. See, *e.g., Dirks v. S.E.C., supra*, 681 F.2d at 844-845 and n. 27.

The consequence of such double and triple dilution of scienter is painfully evident in this case. Here the district court stated, at the close of the plaintiffs' case in the liability phase of trial, that, if it were necessary to liability for aiding and abetting to prove Petitioner had knowledge of alleged

nondisclosure of her relations with USNB, there was a "fatal defect" in plaintiffs' case because "the record is complete now, and . . . [t]here is a hiatus in the case as to that." (RT 6185-86.) Obviously, Petitioner had knowledge of her own transactions with USNB but, as the district court correctly observed, there was no evidence she had knowledge of any supposed failure on the bank's part to make disclosure of these transactions, even assuming she had any reason to believe further disclosure was necessary. The Court of Appeals, however, was satisfied apparently solely on the strength of her knowledge of her own transactions that she had sufficient "scienter" for multi-million dollar liability. On this theory, *Hochfelder*'s exhaustive analysis of the scienter required for § 10(b) and Rule 10b-5 liability is utterly meaningless.

**c. Secondary Civil Liability to All the World Should Not Be Imposed Absent Proof of a Causal Connection Between the Nondisclosure and Any Damages to Plaintiffs.**

Under the Court of Appeals' construction of secondary liability, civil liability becomes a devastatingly punitive consequence of one person's failure to reveal another's breach of duty by nondisclosure. But civil liability is supposed to be compensatory, not punitive. Damages for a violation of § 10(b) and Rule 10b-5 are limited to actual damages proximately caused by the violation. 15 U.S.C. § 78bb(a); *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977); see also *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 388-389 (1970).

Few courts have had occasion to analyze the issues of proximate causation/damages under the section and rule and virtually none in light of theories of secondary liability. The Court of Appeals' opinion in this case, however, endorses

a "but for" analysis of both *transaction* causation and *damages* causation, in conflict with the law of other circuits. See *Edwards & Hanly v. Wells Fargo Securities, etc.*, 602 F.2d 478, 483-485 (2d Cir. 1979), cert. denied 444 U.S. 1045 (1980); *Landy v. Federal Deposit Insurance Corporation*, 486 F.2d 139, 163 (3d Cir. 1973), cert. denied 416 U.S. 960 (1974); *Fridrich v. Bradford*, 542 F.2d 307, 318-23 (6th Cir. 1976), cert. denied 429 U.S. 1053 (1977); *Bonime v. Doyle*, 416 F.Supp. 1372, 1383 (S.D.N.Y. 1976), aff'd. 556 F.2d 554 (2d Cir.), cert. denied 434 U.S. 924 (1977); *Miller v. Schweickart*, 413 F.Supp. 1062, 1068 (S.D.N.Y. 1976); see also Mullaney, *Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability*, 46 Ford.L.Rev. 277 (1977). The Court of Appeals equates an alleged nondisclosure of material facts, which it *presumes* affected purchasers' decisions to acquire USNB stock, with the presumably total loss of shareholders' investment when USNB was closed. (See App., p. 23, and n. 11.) This creates a rule of automatic damages comparable to that recently rejected by this Court in a different context, *J. Truett Payne Co. v. Chrysler Motors Corp.*, 451 U.S. 557 (1981), and imposes ruinous liability without consideration either of the degree of the party's secondary fault or the actual damages attributable to it.

This case illustrates the horrendous consequences of a rule of "presumed damages." In this instance plaintiffs' own expert testified that, even assuming there was something wrong with Petitioner's transactions with USNB (although nothing was shown to be), it would have had no appreciable impact on the value of USNB stock, *i.e.*, neither more detailed disclosure nor its lack affected the value of USNB stock. (RT 9181-83.) Nevertheless, the jury found her liable for damages computed by multiplying the *full* estimated market price of the stock for *all* shares presumed

to have been purchased after March 1, 1971 — an amount exceeding $6,200,000 — consistent with the "last drop in the cup" argument urged by plaintiffs.

One irony of the Court of Appeals' opinion is that if Petitioner had actually traded with the presumed knowledge, instead of doing nothing, her liability would have been limited to disgorgement of profits.[14] *E.g., Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 168-173 (2d Cir. 1980). In other words, under the opinion, in a case of "insider information" liability for insider *trading* is less than for insider *non-trading*, *i.e.*, compliance with a duty to "disclose or abstain" exposes a person to greater liability than non-compliance. Surely this cannot be.

### 3. THE COURT OF APPEALS HAS FURTHER EXPANDED THE REACH OF § 10(b) AND RULE 10b-5 BY EXTENDING THE POTENTIAL CLASS OF PLAINTIFFS FAR BEYOND THE LIMITS RECOGNIZED BY THIS OR ANY OTHER COURT.

The opinion of the Court of Appeals treats the question of pleading. (App., pp. 15-16.) Standing, however, is a jurisdictional requirement and must exist at every stage of the proceedings. See *Gladstone Realtors v. Bellwood*, 441 U.S. 91, 115, n. 31 (1979); *Preiser v. Newkirk*, 422 U.S. 395, 401 (1975); *Steffel v. Thompson*, 415 U.S. 452, 459, n. 10 (1974). Granting that standing is not lost by failure to prevail on the merits, in this case it was established even before trial began that the named plaintiffs had acquired their stock at the latest by early 1968, *i.e.*, before the earliest alleged act involving Petitioner. (CR 877, pp. 2-3.) Nec-

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[14]Thus, Petitioner might well regret that the court refused an insider trading instruction (RT 6291-93) since, over the years, Petitioner never owned more than a few thousand shares of USNB stock on which she either lost about $10,000 or made a profit of less than $15,000 on all transactions. (*E.g.*, HS Exh. 48.)

essarily, the named plaintiffs (only two of whom testified) had no grievance with Petitioner. Necessarily, too, the jury fixed the opening date of liability three years after named plaintiffs had acquired their stock. (CR 1081, 1103.)

The Court of Appeals, however, replaced the "purchaser-seller" and "in connection with" requirements of § 10(b) and Rule 10b-5 with yet another notion derived, like aiding and abetting liability, from the common law and criminal law — that one conspirator is liable for the conduct of other conspirators committed prior to the time of joining the conspiracy — making liability depend not on conduct in connection with the purchase or sale of securities but on whether the jury wants to call secondary liability "conspiracy" instead of "aiding and abetting."[15] Thus, in a single sweep the Court of Appeals couples an unprecedented expansion of standing to sue under § 10(b) and Rule 10b-5 with a virtually limitless construction of what conduct may give rise to liability and then adds the suggestion that liability may be projected endlessly backwards (or forwards) in time. Nothing in § 10(b), or Rule 10b-5 or the case law sanctions such a result. Here, again, the implication is that Petitioner might have been better off by trading on the non-public information she allegedly had instead of doing nothing, as *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 94-95 (2d Cir. 1981) illustrates. There the court reaf-

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[15]The Court's statement that the jury found all appellants liable for conspiracy beginning in 1963 or 1968 (App., p. 16) is not accurate. First, there was simply no evidence linking Petitioner with the other secondary defendants, each of whom was separately linked to C. Arnholt Smith. See *Kotteakos v. United States*, 328 U.S. 750, 772 (1945). Moreover, plaintiffs' attorney himself argued that the *earliest* date Helen could be found liable for anything was March 1968 (RT 7045), and the jury in fact fixed the opening date of liability as March 1971. (CR 1081, 1103.) Contrary to the suggestion of the Court of Appeals, this was hardly an act of largesse on the part of the jury.

firmed its prior holdings, stating:

> "[I]nsider sellers [are] subject to a duty to disclose only to those who purchased the stock 'during the same period' as the insiders' sales. . . . *To extend the period of liability well beyond the time of the insider's trading simply because disclosure was never made could make the insider liable to all the world.* (Citations.) *Any duty of disclosure is owed only to those investors trading contemporaneously with the insider*; non-contemporaneous traders do not require the protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information." (Emphasis added.)

None of the named plaintiffs traded USNB stock contemporaneously with any alleged misconduct by Petitioner.

**4. A DEFENDANT HAS A BASIC DUE PROCESS RIGHT TO KNOW IN ADVANCE OF TRIAL WHO AND WHAT SHE IS TO DEFEND AGAINST. THIS RIGHT IS IN SIGNIFICANT PART PROTECTED BY RULE 23, FEDERAL RULES OF CIVIL PROCEDURE. THE EXTRAORDINARY PROCEDURAL IRREGULARITIES IN THE MANAGEMENT OF CLASS ISSUES, INCLUDING THE DISTRICT COURT'S REFUSAL TO PERMIT PETITIONER TO PRESENT EVIDENCE NEGATING CLASS-BASED ASSUMPTIONS, DENIED PETITIONER DUE PROCESS OF LAW.**

Virtually all discussion of the constitutional dimensions of the class action requirements now embodied in Rule 23, Federal Rules of Civil Procedure focuses on the rights of absent members of the plaintiff class. See, *e.g.*, *Hansberry v. Lee*, 311 U.S. 32, 42 (1940); *Nat. Ass'n. of Regional Medical Programs v. Mathews*, 551 F.2d 340, 345-346 (D.C. Cir. 1976), cert. denied 431 U.S. 954 (1977). These rules, however, are meant to assure due process for defendants as well, including the rule that the determination of whether a class shall be certified should be made as soon

as practicable after commencement of the action. (Rule 23(c)(1).)

In an adversary proceeding, minimal procedural due process requires identification of one's adversaries and the basis of their charges, see *Brouillette v. Board of Dir. of Merged Area IX, etc.*, 519 F.2d 126, 128 (8th Cir. 1975), without which there is no meaningful opportunity to prepare a defense. See, *e.g.*, *Memphis Light, Gas & Water Dis. v. Croft*, 436 U.S. 1, 14 (1978); *Wolff v. McDonnell*, 418 U.S. 539, 564 (1974). Since few rights are more basic to due process than the right to confront and cross-examine adverse witnesses, see, *e.g.*, *Greene v. McElroy*, 360 U.S. 474, 496, n. 25 (1959); *Goldberg v. Kelly*, 397 U.S. 254, 267 (1970), *a fortiori*, the right to confront at least one true adversary whose claims are typical of the class he represents is patently essential in this context.[16]

While a real plaintiff may be only an inconvenient but necessary encumbrance for the attorney seeking to pursue a class action suit, a true, existing representative adversary is a critical element of due process to the defendant. Simply put, it is fundamentally unfair to require a person to defend against a phantom class which, while lacking sufficient substance to put forward a single individual to confront the defendant, is accorded sufficient substance to be awarded a multi-million dollar judgment. The instant action denied Petitioner the basic right to know who and what she was to defend against, indeed to know on what basis her presence

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[16]Indeed, the entire case may hinge on certification; in this case, for example, the named plaintiffs had no individual claims against Petitioner and, absent proper certification of a class of purchasers of bank stock under § 10(b), Petitioner should have been dismissed from the action. See *Libby, McNeill, and Libby v. City Nat. Bank*, 592 F.2d 504, 510 (9th Cir. 1978) [rejecting concept of "pendent party" jurisdiction]; *Avala v. United States*, 550 F.2d 1196, 1198-1200 (9th Cir. 1977), cert. dism. 435 U.S. 982 (1978) [same].

in the action could be compelled at all. A national class was certified under the National Bank Act as one of *shareholders*, and it remained just this class.[17] No class or subclass of *purchasers* was ever framed in terms of § 10(b), the only jurisdictional basis for Petitioner's presence in the action, *Blue Chip Stamps v. Manor Drug Stores*, *supra*, 421 U.S. 723, this despite all protestations by her and the other secondary defendants from the beginning to the end of the proceedings. (See, *e.g.*, RT 19, 52-54, 1567-72, 1600-05, 1614, 1623, 1629-32, 1649-50, 5572-89, 7224-27, 9022-37, 9914-17.)

As a result, Petitioner faced a multi-million dollar judgment (including punitive damages under California law) without any opportunity to test any properly certified class either under § 10(b), the basic source of the court's jurisdiction over her, or under the pendent claims which, it seems clear, could not properly be pursued on behalf of a nationwide class. *Abed v. A. H. Robins Co.*, 693 F.2d 847 (9th Cir. 1982), cert. denied, 74 L.Ed.2d 1015 (1983). Further, she was obliged to do so despite the fact none of the named plaintiffs asserted any grievance against her, and no one actually or purportedly representing stock purchasers ever

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[17]In *Harmsen v. Smith*, *supra*, 542 F.2d 496 (9th Cir. 1976), the Court of Appeals permitted this action, which was then premised on alleged violations of the National Bank Act, to proceed over the objection of the FDIC. Class certification was not before the court, though it was confident its opinion would make review of the certification necessary. (*Id.* at 503.) The certification remained the same, although following remand the complaint was amended to add a bevy of § 10(b) and Rule 10b-5 claims and essentially homologous pendent claims against Petitioner. Having been granted summary judgment on the National Bank Act claim, Petitioner and the other secondary defendants repeatedly asserted (i) named plaintiffs' lack of standing and (ii) the absence of an appropriate class or subclass framed in terms of the jurisdictional basis for the § 10(b) claims, *i.e.*, *purchasers* or *sellers*. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

appeared at trial.[18] Not surprisingly, even the judgment did not identify the persons in whose favor it ran.[19]

The Court of Appeals treated these events as of no practical significance. The court concluded that a jury instruction in the liability phase using the term of art "in connection with the purchase or sale of securities," and one in the damages phase regarding "purchases" of stock were the functional equivalent of an appropriate class certification (App., p. 15); that there was no reason to exclude out-of-state shareholders from the California pendent claims (*id.*, p. 25); that the judgment could be corrected (*id.*, p. 15) and people who didn't belong in the class calculations could be weeded out later (*id.*, pp. 16-17, 23-24, 26-27).[20]

But even assuming the possibility of such reconstructive surgery, the real vice of defending against phantom plaintiffs and the basic issue of due process remain. Petitioner was forced to defend an action in which, as to her, there was no true plaintiff, no one who claimed to have been misled by any alleged nondisclosure regarding her, no one asking that she be punished for any real or imagined wrongdoing.

The fundamental unfairness inherent in the proceedings was further compounded by the district court's refusal to

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[18]The class damages were computed by a Special Master who erroneously assumed all *shareholders* were *purchasers*, with the exception of those who were identifiably not purchasers. He sent out over 4,300 questionnaires, only 1,799 of which were returned. Nevertheless, he assumed these persons were purchasers, and estimated a market price for their stock. The Special Master estimated up to a 30% margin of error on his extrapolations which, nevertheless, were translated by the jury into several million dollars in damages. (See RT 7341-48, 8832-50, 9432.)

[19]It appears that plaintiffs' counsel had lost the opt-out forms returned in response to notice of the proceedings. (RT 8882.)

[20]No consideration was given to the fact that during the sorting out process itself Petitioner may face financial ruin, for example, through a forced sale of the real property securing the face amount of the judgment.

permit Petitioner to introduce evidence negating the assumption that she had wronged some class of persons. If a class action securities case can be tried at all in the absence of a true class and any true adversaries, substituting in its place token pleading requirements and presumptions, a defendant is minimally entitled to offer the best evidence available to negate the charges leveled against her. Thus, where as here, a case rests on a "fraud on the market" theory, see *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied 429 U.S. 816 (1976), and there is no individual plaintiff who can or does testify to the materiality of alleged nondisclosures respecting the defendant, the defendant's *only* recourse is to expert testimony. Here Petitioner offered precisely such expert testimony, *i.e.*, the opinion of an expert who, based on his study of actual market behavior regarding USNB stock, would have opined that no alleged nondisclosure regarding Petitioner's relations with USNB would have significantly altered the average reasonable investor's total mix of information. (RT 5833-35, 5883.) See *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) [defining "materiality"]. The Court of Appeals did not reject the authorities uniformly endorsing the use of such testimony,[21] nor did it suggest any after-the-fact reconstruction of the proceedings by which to discount it. It simply did not address the issue at all.[22]

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[21]See *Marx & Co., Inc. v. Diners' Club, Inc.*, 550 F.2d 505, 509 (2d Cir.), cert. denied 434 U.S. 861 (1977); *United States v. Cohen*, 518 F.2d 727, 737 (2d Cir.), cert. denied 423 U.S. 926 (1975); *Unicorp Fin. Corp. v. First Union, etc.*, 515 F.Supp. 249, 258 (S.D. Ohio 1981); *Reeder v. Mastercraft Electronics Corporation*, 363 F.Supp. 574, 579 (S.D.N.Y. 1973). See also *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 577 (2d Cir.), cert. denied 74 L.Ed.2d 170 (1982) [requiring consideration of actual market behavior].

[22]The prejudicial effect of excluding this testimony was raised in all of Petitioner's briefs, including her petition for rehearing. (AOB, pp. 55-59, ARB, pp. 27-30, Pet. for Rehearing, p. 13.)

Implicitly, perhaps, the opinion may be read to mean that once due process is construed to permit proceedings in which a defendant may be put to trial without knowing who or what to defend against, it is not offended by foreclosing the defendant from making the only defense available.

**Conclusion.**

This petition raises issues of fundamental and widespread importance under § 10(b), Rule 10b-5 and the Fifth Amendment. Petitioner respectfully prays that this Court grant review not merely to correct the gross injustice in this case, but to assure that such injustice does not become the law of the land.

Respectfully submitted,

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## APPENDIX.

### Opinion.

In the United States Court of Appeals for the Ninth Circuit.

Fred H. Harmsen, et al., Plaintiffs-Appellees, vs. C. Arnholt Smith, et al., Defendants-Appellants. Nos. 80-5097/5098/5099; DC Nos. 73-460-WBE, 74-345-WBE.

Filed: December 1, 1982.

Appeal from the United States District Court for the Southern District of California. William B. Enright, District Judge, Presiding. Argued and submitted February 5, 1982.

Before: SKOPIL and SCHROEDER, Circuit Judges, and Aguilar,* District Judge.

SCHROEDER, Circuit Judge.

This case arose out of the failure of United States National Bank (USNB) of San Diego and the disintegration of the financial empire of its former officer, director, and controlling shareholder, C. Arnholt Smith (C. Arnholt). C. Arnholt, in connection with members of his family and the directors and officers of corporations he controlled, allegedly engaged in continuing fraudulent activities from 1962 until 1973. Specifically, C. Arnholt, with his daughter Carol Smith Shannon (Shannon), his brother John, his wife Helen, numerous directors of USNB, and others allegedly materially misled USNB shareholders about the many illegal transactions in which defendants were engaged. These transactions generally took three forms: (1) misrepresentation of loan purposes on the books of USNB; (2) granting of loans in excess of National Bank Act (Bank Act) requirements and for insufficient collateral; and (3) funneling USNB loans for undisclosed personal gain.

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*Honorable Robert P. Aguilar, United States District Judge, Northern District of California, sitting by designation.

On October 18, 1973, the Comptroller of the Currency declared USNB insolvent and appointed the Federal Deposit Insurance Corporation receiver. Subsequently, two class actions on behalf of minority shareholders were filed against C. Arnholt and the other USNB directors; Shannon, Helen, John, and the corporation John controlled, First National Finance Corporation (FNFC), were also named as defendants, along with Phillip A. Toft (Toft), an officer and director of Westgate-California Corporation, a major conglomerate that included many Smith-controlled businesses. The two suits were consolidated into the present action.

In June 1974, the FDIC moved to intervene and be substituted for the minority shareholders. The district court permitted intervention but ruled that, under the Bank Act, the minority shareholders had a cause of action in their own right against the bank directors. We affirmed on interlocutory appeal, holding that minority shareholders have a cause of action under the Bank Act even when the only damage claimed is the diminution of the value of their shares. *Harmsen v. Smith*, 542 F.2d 496, 499 (9th Cir. 1976) (*Harmsen I*).

In May 1979, all directors of USNB, with the exception of C. Arnholt, settled, and were dismissed from the case. A jury trial followed to determine the liability of C. Arnholt, Helen, Shannon, Toft, John, and FNFC. The trial was bifurcated as to questions of liability and damages.

Plaintiffs proceeded in the liability phase of the trial on three general theories. The first theory, an alleged violation of section 93 of the National Bank Act,[1] was tried against

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[1] 12 U.S.C. § 93 provides in pertinent part:

> (a) If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this chapter, all the rights, privileges, and franchises of the as-

C. Arnholt alone. Second, all defendants were alleged to have violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)[2], and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5 (1981)[1]. Primary violations were alleged against C. Arnholt; all other defendants were charged with secondary participation in the violations. The secondary section 10(b) theories alleged were "control person" liability under section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a), aiding and abetting liability, and liability for conspiracy to violate section

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sociation shall be thereby forfeited. Such violation shall, however, be determined and adjudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.

[2]Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protecton of investors.

[1]SEC Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

10(b). Third, pendent state claims of fraud, conspiracy to defraud, abuse of control, and conspiracy to abuse control were tried against all parties.

The jury returned a verdict against C. Arnholt on the Bank Act claim, the section 10(b) primary claim, the section 10(b) conspiracy claim, and the four pendent state claims. Helen, Shannon, Toft, John, and FNFC were found liable for secondary violations of section 10(b) and for pendent state violations of fraud, conspiracy to defraud, and conspiracy to abuse control. No defendant except C. Arnholt was found liable for direct abuse of control.[4]

After the jury returned its verdicts in the liability phase of the trial, the district court, pursuant to plaintiffs' request, appointed a special master to gather data to be presented to the jury regarding plaintiffs' damages. The special master sent questionnaires to all USNB shareholders requesting various information, including the date they purchased their shares. The special master prepared two schedules, one based on the actual responses and one based on extrapolations from the actual responses. These schedules were presented to the jury to be considered in its calculation of

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[4]The nine counts were:

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|---|---|
| Count I | Violation of NBA § 93 |
| Count II | § 10(b) primary |
| Count III | § 10(b) controlling person |
| Count IV | § 10(b) aiding and abetting |
| Count V | § 10(b) conspiracy |
| Count VI | Fraud |
| Count VII | Conspiracy to defraud |
| Count VIII | Abuse of control |
| Count IX | Conspiracy to abuse control |

The jury found the defendants liable on the following counts:

| | |
|---|---|
| C. Arnholt | Counts I, II, V, VI, VIII, IX |
| Helen | Counts III, IV, V, VI, VII, IX |
| Shannon | Counts III, IV, V, VI, VII, IX |
| Toft | Counts IV, V, VI, VII, IX |
| John | Counts IV, VI, VII, IX |
| FNFC | Counts IV, VI, VII, IX |

damages. After instructions by the court, the jury awarded damages of several million dollars on each violation against each defendant.[5] Punitive damages were also awarded against

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[5]The jury awarded damages against each defendant in the following amounts:

| | C. ARNHOLT SMITH |
|---|---|
| Count I | $12,298,708.11 |
| Count II | $12,061,417.72 |
| Count V | $ 8,689,021.25 |
| Count VI | $12,061,417.72 |
| Count VII | $11,614,538.21 |
| Count VIII | $11,085,494.77 |
| Count IX | $10,722,476.62 |
| Punitive Damages (Counts VI, VII, VIII, and IX only) | $11,000,000.00 |
| | HELEN SMITH |
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |
| Punitive Damages (Counts VI, VII and IX only) | $ 750,000.00 |
| | CAROL SMITH SHANNON |
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |
| Punitive Damages (Counts VI, VII and IX only) | $ 3,000,000.00 |
| | PHILIP A. TOFT |
| Count IV | $ 8,689,021.25 |
| Count V | $ 8,689,021.25 |
| Count VI | $ 8,689,021.25 |
| Count VII | $ 8,689,021.25 |
| Count IX | $ 8,083,508.79 |
| Punitive Damages (Counts VI, VII and IX only) | $ 1.00 |
| | JOHN A. SMITH |
| Count IV | $11,614,538.21 |
| Count VI | $11,614,538.21 |
| Count VII | $11,614,538.21 |
| Count IX | $10,722,476.62 |

(footnote continued on following page)

each defendant with respect to the state law violations. Upon motion of the defendants, the court reduced compensatory damages to the maximum amount for which each defendant was found liable under any one count, and retained punitive damages in full.[6]

Each defendant now appeals and raises a number of issues. Aside from questions concerning the general sufficiency of the evidence, the principal contentions of the separate defendants can be summarized as follows:

Helen, joined by the other defendants, focuses her arguments on the propriety of the jury verdict against her under the Securities Exchange Act. As a preliminary matter, she asks this court to reexamine prior holdings that there exists a private right of action under section 10(b).

C. Arnholt does not appeal the adverse verdict of over $12,000,000 for violation of the Bank Act. He does contend, however, that any liability based on section 10(b) or on the pendent state claims was improper because section 93 of the Bank Act provides the exclusive remedy against a bank director.

All of the defendants, other than C. Arnholt, urge that they could not have been secondarily liable under section

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| | |
|---|---|
| Punitive Damages (Counts VI, VII and IX only) | $ 1.00 |
| FIRST NATIONAL FINANCE CORPORATION | |
| Count IV | $ 2,861,957.38 |
| Count VI | $ 2,861,957.38 |
| Count VII | $ 2,861,957.38 |
| Count IX | $ 2,868,933.92 |
| Punitive Damages (Counts VI, VII and IX only) | $ 1.00 |

[6]With respect to C. Arnholt, for example, damages as shown in footnote 5, *supra*, were reduced to $12,298,708.11 compensatory plus $11,000,000.00 punitive. Damages awarded against the other defendants were reduced similarly.

10(b) if no primary violation of the same statute was properly asserted against C. Arnholt. They further argue that if no federal cause of action existed against them under section 10(b), the court was without jurisdiction to consider the pendent state law claims. A key jurisdictional issue is, therefore, the claimed exclusivity of the Bank Act.

John and FNFC's principal argument is that the jury was wrongfully instructed to give conclusive effect to the specific findings made in a related bankruptcy case, *In re Westgate-California Corp.*, No. 74-413 (S.D. Cal. Feb. 9, 1978). The court there found that John and FNFC had been involved in fraudulent transactions with USNB. This court recently reversed that decision. *Westgate-California Corp. v. First National Finance Corp.*, 650 F.2d 1040 (9th Cir. 1981).

Defendants also assert that the pendent state claims are wholly derivative and cannot be maintained by the shareholders themselves. Finally, all defendants also claim irregularities with respect to class certification and the damages calculation.

## I
## Preliminary Issues

We begin with the assertion by Helen that this case presents an appropriate opportunity to "reexamine" the availability of a private right of action under section 10(b) of the Securities Exchange Act. We find no such need. The Supreme Court has clearly established the right of individual enforcement under section 10(b) and Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196, 96 S. Ct. 1375, 1382 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729-30, 95 S. Ct. 1917, 1922-23 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54, 92 S. Ct. 1456, 1470-72 (1972); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6, 13 n.9,

92 S. Ct. 165, 169 (1971). Helen's suggestion that the recent Supreme Court decisions in *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 100 S. Ct. 242 (1979), and *Touche Ross & Co. v. Redington*, 442 U.S. 560, 99 S. Ct. 2479 (1979), cast some doubt on the continued validity of the private right of action under section 10(b) is not persuasive. Those cases considered private rights of action under different statutory provisions with different legislative histories. They do not indicate that section 10(b) falls short of meeting the test for implying private rights of action set forth in *Cort v. Ash*, 422 U.S. 66, 78, 95 S. Ct. 2080, 2088 (1975).

The next issue is the claimed exclusivity of section 93 of the Bank Act. We address whether pendent state law claims or section 10(b) claims can be maintained against C. Arnholt for conduct that also allegedly violates section 93.

The question of the availability of relief under state law for conduct covered by the Bank Act has not been litigated often. This court has, however, in the earlier interlocutory appeal of this case, *Harmsen I, supra*, considered the issue. In *Harmsen I* we stated that

> [P]endent state law claims asserted by the plaintiffs here must be with respect to causes not authorized by reason of Section 93. Violations of federal law resulting in injuries for which shareholders may bring a personal action under Section 93 must be determined and measured by federal law. The relief afforded for such violations is a federal remedy. State law may not afford a similar remedy.

542 F.2d at 502. The *Harmsen* court relied on a much earlier statement by the Supreme Court in *Chesbrough v. Woodworth*, 244 U.S. 72, 78, 37 S. Ct. 579, 582 (1917), that section 93 "is exclusive and precludes a common-law liability for fraud and deceit." This conclusion in *Chesbrough*,

in turn, was based on the Court's earlier opinion in *Yates v. Jones National Bank*, 206 U.S. 158, 27 S. Ct. 638 (1907). The *Yates* Court concluded that the Bank Act cause of action must be exclusive as against pendent state claims in order to shield bank directors from standards of liability that varied from state to state. *Id.* at 178, 27 S. Ct. at 645.

We thus follow our earlier conclusion in *Harmsen I* that, for purposes of uniformity, state law causes of action are not allowable if the allegedly wrongful conduct comes within the scope of the National Bank Act. Liability against C. Arnholt under the pendent claims cannot be supported to the extent that the section 93 cause of action was based on the same conduct. If, on the other hand, the pendent claims against C. Arnholt were based on conduct outside the reach of the Bank Act, considerations of uniformity would not apply, and section 93 would not bar such claims.

The provisions of the Bank Act proscribe specific conduct and are limited in coverage. *See, e.g.*, 12 U.S.C. §§ 82, 84. *See also Harmsen I*, 542 F.2d at 501 (section 93 relief limited to actions proscribed within Chapter 2 of Bank Act). The complaint alleges, and the record clearly shows that C. Arnholt was engaged in fraudulent activity that went far beyond the narrow range of conduct prohibited by the Act. The district court judge specifically so held in his denial of defendants' motion for judgment n.o.v., and we agree. We thus conclude that the district court acted properly in considering the pendent claims against C. Arnholt.

An additional defense argument is that, even if section 93 is not the exclusive remedy against C. Arnholt, the district court did not properly distinguish between the two types of conduct and erroneously permitted the jury to consider evidence of C. Arnholt's section 93 violations when it considered liability under the pendent claims. However, defendants never formulated instructions to meet this present

objection, and we hold that it is waived. *United States v. Burlington Northern, Inc.*, 500 F.2d 637, 639-40 (9th Cir. 1974). *See* 9 C. Wright & A. Miller, *Federal Practice and Procedure* § 2552 (1971). Although a formal objection to proposed instructions may not be required when an appellant has previously made his position sufficiently clear to the trial court, *Kramas v. Security Gas & Oil, Inc.*, 672 F.2d 766, 769 (9th Cir. 1982); *Brown v. Avemco Investment Corp.*, 603 F.2d 1367, 1370-75 (9th Cir. 1979), the record in this case does not reveal that defendants ever advised the district court of their view that the instruction did not correctly state the law.

A separate question is whether section 93 of the National Bank Act restricts our ability to consider the section 10(b) claims. *Harmsen I* and the Supreme Court authority on which that case relied do not require dismissal; allowing a section 10(b) cause of action would not subject bank directors to varying standards of liability from state to state. Moreover, the language of the relevant statutes does not suggest that the Bank Act provision is exclusive. Section 10(b) of the 1934 Act and Rule 10b-5 make it unlawful for "any person" to engage in the conduct therein described. Congress did not exclude banks from the coverage of section 10(b), although it did specifically exempt banks from several other provisions of the securities laws. *See, e.g.*, 15 U.S.C. §§ 77c(a)(2), 77*l*(2); *cf.* 15 U.S.C. § 78c(a)(6). As stated by the Fifth Circuit in *Lehigh Valley Trust Co. v. Central National Bank*, 409 F.2d 989, 993 (5th Cir. 1969), "[t]hat Congress made no express general exemption for banks under the fraud provisions of either the Securities Act of 1933 or the Securities Exchange Act of 1934 indicates that Congress did not intend any such exemption." *Accord Carroll v. First National Bank of Lincolnwood*, 413 F.2d 353 (7th Cir.), *cert. denied*, 396 U.S. 1003, 90 S. Ct. 552 (1969)

(banks subject to provisions of section 10(b)). For its part, the Bank Act provision does not contain any language limiting the application of other federal laws to conduct within its reach.

Defendants fail to articulate any reasons for not applying section 10(b) in this context. The application of section 10(b) to bank directors burdens them with no duties or responsibilities that conflict with the directives of the Bank Act. It does impose additional duties or responsibilities, but we must construe the two potentially overlapping statutes in the manner that gives effect to each. We rely on the well recognized principle that "when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." *Morton v. Mancari*, 417 U.S. 535, 551, 94 S. Ct. 2474, 2483 (1974). We therefore find no basis for holding that C. Arnholt, as a bank director subject to liability under the Bank Act, was exempted from liability under the Securities Exchange Act.

The single Supreme Court decision that discusses any relationship between the National Bank Act and the Securities Exchange Act is fully consistent with our conclusion. In *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 96 S. Ct. 1989 (1976), the Court held that the venue provision of the Bank Act, 12 U.S.C. § 94, governed venue in a suit against a national banking association for violation of the Securities Exchange Act. Although the focus of the Court in *Radzanower* was on the language and history of the venue provisions, the issue of venue would not have been considered at all had the Court felt that the Securities Exchange Act cause of action was improper because a national bank could be sued only under the Bank Act. We thus hold that there was no error in allowing causes of action under both section 10(b) of the Securities Exchange Act and section 93

of the Bank Act.

Because we hold that section 93 of the Bank Act is not an exclusive federal remedy, and that there was no error in allowing plaintiffs to proceed against C. Arnholt for primary violations of section 10(b) or for alleged violations of state law (pendent claims), the remaining preliminary challenges are necessarily decided. It is unnecessary to consider the other defendants' argument that no secondary section 10(b) violations can properly be asserted unless a primary 10(b) violation is properly asserted. It is also clear that, because both the primary and secondary 10(b) claims were proper, there was an independent federal jurisdictional basis for the court to consider the pendent state claims against the other defendants. *United Mine Workers v. Gibbs*, 383 U.S. 715, 725, 86 S. Ct. 1130, 1138 (1966).

## II
## Pendent Claims

### A. Plaintiffs' Standing Under State Law to Assert Pendent Claims

The defendants argue that the pendent claims asserted by the plaintiffs are, under California law, derivative claims which could not have been brought on the plaintiffs' own behalf but only on behalf of the bank.[7] The leading California case on a stockholder's right to sue in an individual capacity is *Jones v. H. F. Ahmanson & Co.*, 1 Cal.3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969). Chief Justice Traynor's opinion in that case recognized the general rule that there is no individual right of action for conduct of majority shareholders and directors which decreases the value

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[7]It is clear that a derivative claim could only have been brought against USNB by the FDIC. *Harmsen I*, 542 F.2d at 500-01 n.2. *See Landy v. Federal Deposit Insurance Corporation*, 486 F.2d 139, 146-48 (3d Cir. 1973), *cert. denied*, 416 U.S. 960, 94 S. Ct. 1979 (1974).

of the corporation's stock. It went on to hold, however, that minority shareholders could assert a cause of action for injury to themselves, as opposed to injury to the corporation or injury incidental to the corporation's. *Id.* at 107, 460 P.2d at 471, 81 Cal. Rptr. at 599. The decision stressed the duty of majority shareholders to refrain from using their power to benefit themselves at the expense of the minority shareholders. *Id.*[8]

In this case the district court considered this standing question in light of applicable California authority; it concluded that the duty allegedly violated here was a duty to the shareholders separate from the duty to the bank and that the claimed injury was to the shareholders as individuals. In addition, the court carefully instructed the jury that it should consider only individual injury to the shareholders, i.e., injury separate from any injury to the bank and not incidental to the bank's injury.

We conclude that the district court did not err in its application of California law to the question of the standing of the shareholders to bring the pendent claims. The shareholders were allegedly damaged in that they were induced to buy and hold stock which was worthless and which they would have known was worthless had they been aware of the defendants' misdeeds. The shareholders' injury is thus greater than the mere diminution of the value of their stock, for which only the corporation or a shareholder acting de-

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[8]California courts have consistently applied the *Ahmanson* analysis to suits brought by individual shareholders. *See, e.g., Smith v. Tele-Communications, Inc.*, 134 Cal. App. 3d 338; 184 Cal. Rptr. 571 (1982) (minority shareholder action based on fraud upheld as individual suit); *Crain v. Electronic Memories and Magnetics*, 50 Cal. App. 3d 509, 123 Cal. Rptr. 419 (1975) (same). *Cf. Truestone, Inc. v. Travellers Insurance Company*, 55 Cal. App. 3d 168, 127 Cal. Rptr. 386 (1976) (suit for diminution of value of shares allowed because not incidental to injury to corporation—third party tortfeasor had independent duty to individual shareholders.)

rivatively may normally seek recovery. The injuries here are properly characterized as "separate individual damages." *Sherman v. British Leyland Motors, Ltd.*, 601 F.2d 429, 440 n.13 (9th Cir. 1979).

B. Sufficiency of the Evidence—Pendent Claims

Defendants argue that there was insufficient evidence to support the jury's verdict on fraud, conspiracy to defraud, and conspiracy to abuse control. The principal contention is that plaintiffs failed to show that the defendants' involvement in concealed transactions had any material bearing on the purchase of shares. The record does contain expert opinion on the materiality of the concealed transactions. This opinion testimony was based on the undisclosed nature of the transfers between family-controlled entities, as well as on the size of the transactions. The record contains ample evidence of a conspiracy to misuse C. Arnholt's controlling position. Helen cannot logically maintain that because the jury refused to find that she herself abused control, it could not find that she conspired with C. Arnholt in connection with his abuse. The jury verdicts were supported.

III.

Class Certification and Related Issues

A. Class certification

Early in this litigation, before plaintiffs asserted any section 10(b) cause of action, the district court, pursuant to Fed. R. Civ. P. 23(b)(3), certified a class consisting of USNB shareholders as of October 18, 1973, the date the receiver was appointed. The section 10(b) claims were added to the class complaint after this court's decision in *Harmsen I, supra*.

The defendants correctly argue that only purchasers or sellers of stock have standing to bring a section 10(b) action,

*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55, 95 S. Ct. 1917, 1934-35 (1975), and that the class certification should have been modified to include purchasers rather than shareholders. However, the erroneous denomination of the certified class was of no practical consequence; the instructions of the district court in the liability phase of the trial expressly required that the jury find against defendants on the section 10(b) and Rule 10b-5 claims only if plaintiffs established that defendants' conduct was "in connection with the purchase or sale of securities." In addition, in the damages phase of the trial, the jury was specifically instructed to find damages based on purchases of stock. Given the district court's specific and unambiguous instructions to the jury that only purchasers of stock could recover, appellants did not suffer any prejudice because the trial court failed formally to certify a sub-class of purchasers.

Defendants also complain that the district court erroneously failed to comply with Rule 23(c)(3) because the judgment did not describe the members of the class to whom they were liable. The present deficiency in the judgment has not prejudiced defendants and can easily and appropriately be corrected. On remand from this court, the district court shall enter judgment in accordance with Rule 23. *See Newman v. Prior*, 518 F.2d 97, 101 (4th Cir. 1975); *Young v. Katz*, 447 F.2d 431, 435 (5th Cir. 1971).

B. 10(b) Standing of class representatives

Helen, Shannon, and Toft all contend that plaintiffs lack standing to pursue section 10(b) claims against them because the two named plaintiffs who testified at trial both purchased their shares before 1968; the jury found that this was the earliest year in which these defendants were actually involved in the securities law violations. Plaintiffs correctly respond that standing must be determined from the pleadings

rather than from the liability actually imposed.

The pleadings in this case establish plaintiffs' standing. The Constitution's "case or controversy" requirement (U.S. Const. art. 3, § 2) with respect to standing is met when plaintiffs allege that they have suffered some injury as a result of defendants' illegal conduct. *Linda R.S. v. Richard D.*, 410 U.S. 614, 617, 93 S. Ct. 1146, 1148 (1973). *See also Dupree v. United States*, 559 F.2d 1151, 1153 (9th Cir. 1977). Plaintiffs here alleged a series of securities violations and a conspiracy that caused them damages. Defendants may be liable for all the actions of their co-conspirators, even those that occurred before the particular defendants joined the conspiracy. *United States v. Saavedra*, 684 F.2d 1293 (9th Cir. 1982); *United States v. Traylor*, 656 F.2d 1326, 1337 (9th Cir. 1981). *See also In re Equity Funding Corp.*, 416 F. Supp. 161, 180 (C.D. Cal. 1976). Moreover, the factual issues denominated in the pretrial order in this case clearly covered the defendants' participation as aiders and abettors and as conspirators for a period beginning in 1960. The jury found all appellants liable for conspiracy beginning in 1963. The jury was further instructed at the damage phase that it could hold each defendant liable for all damages which accrued during the conspiracy period.

The jury chose, however, to assess damages against each defendant (other than C. Arnholt) for the period the jury found that each was actually involved in C. Arnholt's deceptions. In this way, the jury found Helen, Shannon, and Toft liable only to purchasers who bought their shares after 1968; the named plaintiffs are therefore not able to recover from these defendants.

This result does not mean, however, that the named plaintiffs lacked standing. These plaintiffs had standing to pursue the action in the first instance. Standing ordinarily does not

depend upon the merits of a plaintiff's contentions; the requirement is based upon a separate determination that the plaintiffs have made "allegations of demonstrable, particularized injury." *Warth v. Seldin*, 422 U.S. 490, 508, 95 S. Ct. 2197, 2210 (1975). As we have stated, "failure of proof as to the named plaintiffs would not bar maintenance of the class action or entry of judgment awarding relief to the members of the class." *Gibson v. Local 40, Supercargoes & Checkers, Etc.*, 543 F.2d 1259, 1263 (9th Cir. 1976) 63 [sic]. *See also East Texas Motor Freight System v. Rodriquez*, 431 U.S. 405, 406 n.12, 97 S. Ct. 1891, 1898 (1977), where the Court, *citing Franks v. Bowman Transportation Co.*, 424 U.S. 747, 752, 96 S. Ct. 1251, 1258 (1976), stated that "[p]rovided the initial certification was proper and decertification not appropriate, the claims of the class members would not need to be mooted or destroyed because subsequent events or the proof at trial had undermined the named plaintiffs' individual claims." All plaintiffs had standing to pursue their section 10(b) claims against the defendants.

C. Adequacy of Class Representation

A different question is presented with respect to whether the named plaintiffs were appropriately certified as adequate class representatives under Rule 23(a). A district court's determination as to adequacy of representation will be overturned only if the district court abused its discretion. *Patterson v. Schlesinger*, 625 F.2d 262 (9th Cir. 1980); *Clark v. Watchie*, 513 F.2d 994 (9th Cir. 1975). There was no abuse of discretion in this case. Insofar as the defendants argue that the named representatives are not typical of the class members who purchased shares later, their position is contrary to *Blackie v. Barrack*, 524 F.2d 891, 902, 911 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S. Ct. 57

(1976). The suit was properly conducted as a class action.

IV

Sufficiency of the Evidence—Section 10(b) Claims

Each defendant was found liable for at least one secondary violation of section 10(b) of the Securities Exchange Act. Helen, Shannon, Toft, John, and FNFC were found liable under an aiding and abetting theory. C. Arnholt, Helen, Shannon, and Toft were found to have conspired to violate section 10(b). Helen and Shannon were found secondarily liable as control persons of a primary section 10(b) violator. The district court limited compensatory damages to the greatest amount assessed under any one count. Because the amounts awarded under the separate section 10(b) secondary counts were identical (and equal to or larger than the amounts awarded under the pendent claims), we need only sustain one secondary violation of section 10(b) as to each defendant in order to sustain the judgment.[9] We conclude that all defendants were properly found liable as aiders and abettors.

The elements of a cause of action for aiding and abetting under section 10(b) are: (1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong. *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919, 101 S. Ct. 317 (1980); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3d

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[9]Because C. Arnholt does not appeal the adverse verdict under section 93 of the Bank Act, and damages awarded against C. Arnholt under the Bank Act count were greater than damages awarded under any other count, the judgment against him can therefore be sustained without addressing his conspiracy liability under 10(b). His violation of 10(b) is, of course, relevant to consideration of the other defendants [sic] secondary liability.

Cir.), *cert. denied*, 439 U.S. 930, 99 S. Ct. 318 (1978); *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 886 (3d Cir. 1975); *Woodard v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975); *In re Gap Stores Securities Litigation*, 457 F. Supp. 1135, 1143-44 (N.D. Cal. 1978); *In re Equity Funding Corp.*, 416 F. Supp. at 180. *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 627-38 (1972).

The first element is satisfied by the primary violation of section 10(b) by C. Arnholt. His fraudulent loans, material omissions, nondisclosures, and positive misrepresentations clearly constituted violations of section 10(b) and Rule 10b-5. The jury was properly instructed on the elements of a 10(b) and 10b-5 cause of action, and there is ample record evidence to support these violations.

The existence of the second and third elements as to Helen, Shannon, and Toft is also supported by the record. Although Helen testified that she never discussed USNB with C. Arnholt, the record shows that Helen had numerous business dealings with USNB, including transactions in which she received loans at non-market terms and acquired real property at minimal cost. There is sufficient evidence from which the jury could conclude that she knew that potential investors were being deceived by C. Arnholt. Taken in the light most favorable to the plaintiffs, the evidence also adequately supports the jury's finding that Helen knowingly provided substantial assistance in the fraud. *See IIT*, 619 F.2d at 923-28; *Monsen*, 579 F.2d at 799-801; *cf. Investors Research Corp.*, 628 F.2d at 178.

Helen asks us to declare that there can be no liability premised on aiding and abetting a violation of section 10(b). Such a result has been suggested as a possible consequence of the United States Supreme Court decisions in *Touche*

*Ross & Co. v. Redington*, 442 U.S. 560, 99 S. Ct. 2479, 61 L.Ed.2d 82 (1979) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1775, 47 L.Ed.2d 668 (1976). *See Securities & Exchange Comm. v. Seaboard Corp.*, 677 F.2d 1301, 1311 n.12 (9th Cir. 1982) (dictum); Fischel, *Secondary Liability under § 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80 (1981). However, the Supreme Court has not yet seen fit to follow that suggestion. Further, other circuits have stated that aider and abettor liability under section 10(b)(5) continues to exist. *See Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982); *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566 (2d Cir.), *cert. denied*, 51 U.S.L.W. 3281 (U.S. Oct. 12, 1982) (No. 82-236); *Stokes v. Lokken*, 644 F.2d 779, (8th Cir. 1981); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930, 99 S. Ct. 318 (1978). Our own decision in *Strong v. France*, 474 F.2d 747 (9th Cir. 1973) discusses the methods of establishing aider and abettor liability. In the absence of any authority or compelling reasons for holding that aider and abettor liability no longer exists, we hold that it remains a viable part of securities regulation.

Shannon and Toft also argue that aider and abettor liability cannot be applied to them because they were under no duty to disclose to USNB shareholders. *Chiarella v. United States*, 445 U.S. 222, 100 S. Ct. 1108 (1980). This contention blurs the distinction between primary and secondary violations of section 10(b). While C. Arnholt's duty to disclose arises from his position in the bank and his relationship to the shareholders, *Id.* at 227-28, 100 S. Ct. at 1114, the secondary violater's duty arises from "knowing assistance of or participation in a fraudulent scheme." *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973) (quoting *Anderson v. Francis I. duPont and Co.*, 291 F. Supp. 705, 709

(D. Minn. 1968)).[10] The record clearly shows that the jury was presented with sufficient evidence surrounding transactions involving both Shannon and Toft from which it could find knowing assistance or participation.

## V

## The Westgate Instructions

The district court instructed the jury to give conclusive effect to certain findings made in the Westgate California Corporation bankruptcy proceedings regarding John's involvement in fraud, including a finding that John was "an integral part of the fraud involving Westgate California Corporation and the United States National Bank . . . ." This court, however, after the trial in this case, reversed the *Westgate* bankruptcy decision, noting that "the record as presented to us is inadequate to support a determination that J.A. Smith behaved inequitably." *Westgate-California Corp. v. First National Finance Corp.*, 650 F.2d 1040, 1044 n.1 (9th Cir. 1981). We now know, therefore, that the *Westgate* findings were not entitled to the conclusive effect that the jury was instructed to give them, and that the instruction was erroneous. *Butler v. Eaton*, 141 U.S. 240, 242, 11 S. Ct. 985, 986 (1891) (9th Cir. 1980) [sic]; Restatement (Second) of Judgments § 16, comment c (1982) (when a later judgment is based upon an earlier judgment which is set aside or reversed, "[t]he court should then normally set aside the later judgment").

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[10]Other cases involving aider and abettor liability have also recognized that such liability exists even when the secondary violator owes no duty to the plaintiffs. *See, e.g., Sirota*, 673 F.2d at 575 (existence or nonexistence of duty on part of aider and abettor only relates to degree of scienter needed to prove violation—less scienter suffices when duty present); *IIT*, 619 F.2d at 927 (same); *Monsen*, 579 F.2d at 800 (conscious aiding and abetting liability not predicated on existence of duty).

The plaintiffs correctly point out that the record nevertheless contains evidence which would independently support the verdict against John and FNFC. The problem is, however, that it is impossible to evaluate what the jury might have done, had it not been instructed to give conclusive weight to the *Westgate* findings. We recently held that an erroneous instruction in a civil case was harmless error where there was ample evidence for the jury's conclusion. We stated:

> An erroneous ruling which relates to the substantial rights of a party is grounds for reversal unless it affirmatively appears from the whole record that it was not prejudicial. *McCandless v. United States*, 298 U.S. 342, 347-48, 56 S. Ct. 764, 766, 80 L.Ed. 1205 (1936). This is especially true of an error in jury instructions. *Fillippon v. Albion Vein Slate Co.*, 250 U.S. 76, 82, 39 S. Ct. 435, 437, 63 L.Ed. 853 (1919).

*Chancellier v. Federated Dept. Stores*, 672 F.2d 1312, 1316 (9th Cir. 1982). Applying that standard, we cannot hold that the error here is harmless. The verdict against John A. Smith and FNFC must therefore be reversed.

## VI
## Damages

Damages were determined by the jury in a proceeding separate from the determination of liability. Each defendant claims a number of errors in the damages phase of the trial.

Defendants first argue that the calculation of damages was speculative. Defendants are correct in asserting that the plaintiff in a securities fraud action has the burden of proving that damages flowed from the alleged injury. *Rochez Brothers v. Rhoades*, 527 F.2d 891, 894 (3d Cir. 1975). *See Mills v. Electric Auto-Lite*, 396 U.S. 375, 388 (1969) ("damages should be recoverable only to the extent they can be shown").

Although damages need not be proved to a mathematical certainty, "sufficient facts must be introduced so that a court can arrive at an intelligent estimate without speculation or conjecture." 527 F.2d at 895. *See also LeLandais & Company v. MDS Atron*, 543 F.2d 421, 424 & n.5 (2d Cir.), *cert. denied*, 429 U.S. 1062, 97 S. Ct. 786 (1976) (failure to adequately show damages prevents recovery).

In this case, a special master, appointed by the trial judge, sent questionnaires to USNB shareholders requesting various information, including the date they purchased their shares. Forty-two percent of the questionnaires were returned. From the information provided, the special master prepared schedules based both upon the actual responses and upon extrapolations from them.

We are persuaded that the procedures used by the trial court do not constitute reversible error. The special master's report was intended to provide information from which the jury could calculate injury to the plaintiff class as a whole. The questionnaires, which included information about dates of share purchases, sufficiently served this purpose. Further, as noted above, the jury was specifically instructed to find damages based upon purchases of stock. The jury was instructed that plaintiffs were required to prove that damages were suffered as "a proximate result of the alleged misleading statements or omission, and the purchase of stock in reliance to [sic] that."[11] It may well be that not all class

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[11]Proof of each plaintiff's reliance on the misrepresentations or omissions is not a prerequisite to recovery. As we stated in *Blackie v. Barrack*, 524 F.2d 891, 905 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S. Ct. 57 (1976), "[t]he amount of damages is invariably an individual question and does not defeat class action treatment. . . . Individual questions of reliance are likewise not an impedement [sic]—subjective reliance is not a distinct element of proof of 10b-5 claims . . . ."

Further, if omissions or nondisclosures meet the standard of materiality to a reasonable investor, *see TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S. Ct. 2126, 2133 (1976); *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1266 (9th Cir. 1979), causation and reliance can be assumed. *Affiliated Ute Citizens v. United States*, 406 U.S. 128,

(footnote continued on following page)

members will make claims against the defendants. If there are excess damage funds after distribution, the district court should consider any feasible methods of returning that excess, with appropriate interest, to defendants.

Shannon and Toft argue that the procedure was fatally defective because the damages were not awarded with respect to the specific time periods for which the various defendants were found liable. This argument has no basis in fact. The jury was provided with damages forms which specifically indicated the beginning and ending dates of each defendant's liability as determined in the liability phase of the trial. The jury was well aware of the time frame of each defendant's liability.

Defendants next argue that no damages can be awarded for conduct after 1968 because plaintiffs' expert testified that USNB stock was worthless as of that date. This argument misconstrues the basis for defendants' liability. Defendants were found liable for failing to disclose material information which would have affected an investor's decision whether to purchase USNB stock. The worthlessness of USNB stock actually evidences the effect of this failure; damages were, in fact, created by the non-disclosures.

Defendants' final argument on compensatory damages is that the district court improperly included certain shareholders in the plaintiff class. These allegedly improper class members were all non-California purchasers, the Franklin National Bank and the Westgate California Insurance Company. Each of the challenged members will be treated in turn.

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153-54. 92 S. Ct. 1456, 1472 (1972); *Blackie*, 524 F.2d at 906

With respect to the pendent claims, defendants do not contend that a showing of reliance was necessary, and, if so, that it was lacking in this case.

Prior to the district court's instructions on damages, defendants argued that the class eligible for recovery on the pendent claims should not include out-of-state purchasers. Their theory was that non-California purchasers should not be permitted to recover for causes of action based on California law. The district court denied defendants' motion because the issue, raised for the first time some six years after the inception of the suit, had not been introduced in a timely manner.

Even assuming that the district court erroneously denied defendants' motion on grounds of untimeliness, defendants have not demonstrated grounds for barring the out-of-state plaintiffs from obtaining recovery on the pendent claims. The district court would have been required to apply the substantive law of the state in which it sits, including choice-of-law rules. *Gee v. Tenneco, Inc.*, 615 F.2d 857, 861 (9th Cir. 1980). Defendants have failed to show, as required by California law, that the law of other states relating to the pendent claims is significantly different from California's and, more importantly, that the interests of other states would be impaired by application of California law to these non-resident plaintiffs. *Id.*; *Offshore Rental Co. v. Continental Oil Co.*, 22 Cal.3d 157, 164-66, 583 P.2d 721, 725-27, 148 Cal. Rptr. 867, 871-73 (1978); *Hurtado v. Superior Court*, 11 Cal.3d 574, 579-80, 522 P.2d 666, 669, 114 Cal. Rptr. 106, 109 (1974). There appears no other reason to exclude the out-of-state purchasers from participating in pendent claims arising from conduct in California.

Franklin National Bank was the pledgee of USNB stock. Defendants argue that a pledge of stock is not a "purchase or sale" for purposes of section 10(b) and Rule 10b-5. Plaintiffs rely on *Rubin v. United States*, 449 U.S. 424, 101 S. Ct. 698 (1981), which held that a pledge constitutes an "offer or sale" for purposes of section 17(a) of the Secu-

rities Act of 1933, 15 U.S.C. § 77q(a).

Defendants have offered no persuasive reason why a pledge of shares of stock should not similarly satisfy the purchase or sale requirement of section 10(b) and Rule 10b-5. We think this result flows logically from *Rubin*. *Cf. Marine Bank v. Weaver*, 455 U.S. 551, ___, 102 S. Ct. 1220, 1222 n.2 (1982) (*Rubin* held that "a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws"). As the Court stated in *Rubin*:

> The economic considerations and realities present when a lender parts with value and accepts securities as collateral security for a loan are similar in important respect to the risk an investor undertakes when purchasing shares. Both are relying on the value of the securities themselves, and both must be able to depend on the representations made by the transferor of the securities, regardless of whether the transferor passes full title or only a conditional and defeasible interest to secure repayment of a loan.

449 U.S. at 431, 101 S. Ct. at 702 (footnote omitted). This language fully supports our conclusion that Franklin National Bank, even though it had less than a complete interest in the pledged shares, should be able to remain in the plaintiff class and recover damages for violations of section 10(b) and Rule 10b-5.

The same result is not appropriate for Westgate California Insurance Company. C. Arnholt was the controlling shareholder of that company. Defendants argue that it would be inequitable for a company controlled by the central defendant in a lawsuit to recover as a member of the plaintiff class. We agree. All defendant shareholders were expressly excluded from the plaintiff class. Although Westgate was not a defendant, we think the same principle should apply

to an entity that is so closely related to a defendant. Westgate should not recover damages. On remand, the district court should consider whether the inclusion of Westgate[12] in class schedules on damages measurably effected [sic] the amount of damages awarded and whether a corresponding reduction in damages is appropriate.

Finally, Shannon, Toft, and Helen argue that the punitive damages awards were excessive. We cannot agree. This court will not overturn an award of punitive damages "unless it appears that the jury was influenced by passion or prejudice." *Glovatorium, Inc. v. NCR Corporation*, No. 81-4453, slip op. at 3688 (9th Cir. Aug. 20, 1982); *Moore v. Greene*, 431 F.2d 584, 593-94 (9th Cir. 1970). Neither the amount of punitive damages awarded in relation to the compensatory damages nor any other evidence indicates that the jury was influenced by passion or prejudice. The jury was correctly instructed that punitive damages should only be awarded if the jury believed that the defendants acted with malice. The term malice was correctly defined. The award of punitive damages will not be disturbed.

## VII
## Conclusion

The judgments against all defendants except John and FNFC are affirmed. The judgments against John and FNFC are reversed.

The district court must design and execute a claims procedure consistent with this opinion. As recognized by the

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[12]John's argument on this issue refers to shares held by Westgate *Life* Insurance Co., a separate entity from Westgate California Insurance Co. The record shows that the inclusion of shares held by Westgate California Insurance Co. was called into question during examination of the special master, and we assume that these shares are the subject of the present dispute. Westgate California Insurance Co. owned over 41,000 shares of USNB.

district court's amendment to judgment, amounts already paid by settling defendants are to be offset. The class of eligible plaintiffs will not include Westgate California Insurance Company.

Affirmed in part; Reversed in part; Remanded.

**Judgment.**

United States District Court, Southern District of California.

Fred H. Harmsen, Ken Hansen, Samuel Rosenberg and James P. Young, et al., Plaintiffs, vs. C. Arnholt Smith, et al., Defendants. Consolidated Civil Actions Nos. 73-460-E and 74-345-E.

Filed: January 2, 1980.

The claims of named plaintiffs FRED H. HARMSEN, KEN HANSEN, SAMUEL ROSENBERG and JAMES P. YOUNG, and of the class which they represent, against defendants C. ARNHOLT SMITH, HELEN SMITH, CAROL SMITH SHANNON, PHILIP A. TOFT, M. J. COEN, JOHN A. SMITH, FIRST NATIONAL FINANCE CORPORATION, U. S. HOLDING COMPANY, SAN DIEGO PADRES and FIRST CALIFORNIA COMPANY, came on for jury trial on August 6, 1979 for the liability phase, and, before the same jury, on December 6, 1979 for the damage phase. The issues having been duly tried, and the jury having rendered its liability verdict on October 12, 1979 and its damage verdict on December 21, 1979,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that judgment is as follows:

1. As to defendant C. ARNHOLT SMITH, judgment against said defendant and in favor of the named plaintiffs and the class which they represent, on the following counts and in the following amounts:

| | |
|---|---|
| Count I | $12,298,708.11 |
| Count II | $12,061,417.72 |
| Count V | $ 8,689,021.25 |
| Count VI | $12,061,417.72 |
| Count VII | $11,614,538.21 |
| Count VIII | $11,085,494.77 |

| | |
|---|---|
| Count IX | $10,722,476.62 |
| Punitive Damages (Counts VI, VII, VIII and IX only) | $11,000,000.00 |

2. As to defendant HELEN SMITH, judgment against said defendant and in favor of the named plaintiffs and the class which they represent, on the following counts and in the following amounts:

| | |
|---|---|
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |
| Punitive Damages (Counts VI, VII and IX only) | $ 750,000.00 |

3. As to defendant CAROL SMITH SHANNON, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |

| | |
|---|---|
| Punitive Damages (Counts VI, VII and IX only) | $ 3,000,000.00 |

4. As to defendant PHILIP A TOFT, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count IV | $ 8,689,021.25 |
| Count V | $ 8,689,021.25 |
| Count VI | $ 8,689,021.25 |
| Count VII | $ 8,689,021.25 |
| Count IX | $ 8,083,508.79 |
| Punitive Damages (Counts VI, VII and IX only) | $ .00 |

5. As to defendant M. J. COEN, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 8,689,021.25 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 8,689,021.25 |
| Count IX | $ 8,083,508.79 |
| Punitive Damages (Counts VI, VII and IX only) | $ 3,000,000.00 |

6. As to defendant JOHN A. SMITH, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count IV | $11,614,538.21 |
| Count VI | $11,614,538.21 |
| Count VII | $11,614,538.21 |
| Count IX | $10,722,476.62 |
| Punitive Damages (Counts VI, VII and IX only) | $ 1.00 |

7. As to defendant FIRST NATIONAL FINANCE CORPORATION, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count IV | $ 2,861,957.38 |
| Count VI | $ 2,861.957.38 |
| Count VII | $ 2,861,957.38 |
| Count IX | $ 2,868,933.92 |
| Punitive Damages (Counts VI, VII and IX only) | $ 1.00 |

8. As to defendant U. S. HOLDING COMPANY, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on all counts in the amount of $12,298,708.11 in compensatory damages, and $1.00 in punitive damages.

9. As to defendant SAN DIEGO PADRES, judgment against said defendant and in favor of the named plaintiffs

and the class which they represent on all counts in the amount of $12,298,708.11 in compensatory damages, and $1.00 in punitive damages.

10. As to defendant FIRST CALIFORNIA COMPANY, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on all counts in the amount of $12,298,708.11 in compensatory damages, and $1.00 in punitive damages.

11. As to all defendants, judgment against all defendants and in favor of the named plaintiffs and the class which they represent for the costs of suit herein.

Dated 1/2/80.

/s/ William B. Enright
WILLIAM B. ENRIGHT
Judge, U.S. District Court

**Amendment to Judgment.**

United States District Court, Southern District of California.

Fred H. Harmsen, et al., Plaintiffs, v. C. Arnholt Smith, et al., Defendants. Civil Nos. 73-460-E, 74-345-E.

Filed: January 16, 1980.

Upon motion of defendants, the court hereby amends its Judgment in this case, entered January 4, 1980, to add the following concluding paragraph:

> "The liability of each defendant is no greater than the largest sum such defendant has been found liable for as to any one count, plus the amount of any punitive damages for that particular defendant. Any payment by any defendant shall reduce by like amount the amount of liability of every other defendant, except punitive damages which are the sole responsibility of the particular defendant against whom punitive damages have been assessed."

This paragraph shall be deemed to be incorporated into the judgment entered January 4, 1980.

It is so ordered.

DATED: January 16, 1980.

/s/ William B. Enright, Judge
WILLIAM B. ENRIGHT, Judge
United States District Court

Copies to:
Plaintiffs
Defendants

## Constitutional Provisions, Statutes and Regulations Involved.

Securities Exchange Act of 1934, Sec. 10(b) (15 U.S.C. § 78j(b))

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5 (17 C.F.R. § 240.10b-5)

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme or artifice to defraud
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Securities Exchange Act of 1934, Sec. 20(a) (15 U.S.C. § 78t(a))

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Securities Exchange Act of 1934, Sec. 28(a) (15 U.S.C. § 78bb(a))

(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of . . . .

Fifth Amendment to the United States Constitution.

No person shall be . . . deprived of life, liberty, or property, without due process of law. . . .

Rule 23, Federal Rules of Civil Procedure

Rule 23, Class Action.

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and ade-

quately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Con-

ducted Partially as Class Actions.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude him from the class if he so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel.

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

(d) Orders in Conduct of Actions. In the conduct of actions to which this rule applies, the court may make

appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(e) Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

Office-Supreme Court, U.S.
F I L E D
AUG 16 1983
ALEXANDER L. STEVAS,
CLERK

No. 82-1980
IN THE

# Supreme Court of the United States

October Term, 1982

HELEN SMITH,

*Petitioner,*

*vs.*

FRED H. HARMSEN, *et al.*,

*Respondents.*

## SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

JENNINGS, ENGSTRAND & HENRIKSON,
PAUL D. ENGSTRAND,
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No. 82-1980

IN THE

# Supreme Court of the United States

October Term, 1982

HELEN SMITH,

*Petitioner,*

*vs.*

FRED H. HARMSEN, *et al.*,

*Respondents.*

## SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

### Introduction.

On July 1, 1983, this Court issued the decision in *Dirks v. Securities and Exchange Commission*, ___ U.S. ___, 51 U.S.L.W. 5123, which provides additional support for the issues raised in Helen Smith's Petition for Writ of Certiorari. In accordance with Rule 22.6 of this Court's rules, we submit this supplemental brief analysing the direct relevance and impact of the *Dirks* decision to the issues raised in the pending petition.[1]

[1]As provided by Supreme Court Rule 22.5, we are concurrently filing a very limited reply to Respondents' highly misleading and inaccurate opposition to the petition for certiorari. The instant supplemental brief accordingly does not address issues raised in Respondents' opposition, but is limited to analysing the impact of the recent *Dirks* decision.

**This Court's Decision in Dirks Re-Confirms That the Requisites for Primary Liability Under § 10(b) and Rule 10b-5 Apply Equally to Causes of Action Premised on Secondary Violations of Securities Law. It Thus Further Compels Reversal of the Court of Appeals' Decision Which Improperly Lowers the Standards for Secondary Liability to the Point That Banks, Law Firms, Accounting Firms, and All Other Third Parties Who May Have Access to Nonpublic Information Will Henceforth Be Exposed to Liability Coextensive With That of the Primary Violator if They Simply Fail to Monitor and Expose Violations of Securities Law by the Stock Issuer.**

On July 1, 1983, this Court issued its decision in *Dirks v. Securities and Exchange Commission* which underscores and further validates one of the principal contentions raised in Helen Smith's Petition for Writ of Certiorari, namely, that there can be no secondary liability for aiding and abetting violations of the securities law unless the conduct of the secondary defendant satisfies each of the requisite elements of a cause of action for primary civil liability under § 10(b) and Rule 10b-5.[2] Those elements are: (a) a duty to

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[2]In *Dirks*, there was no need for the Court to address the more basic question raised in our Petition and expressly reserved in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-192, n.7 (1976), and *Herman & MacLean v. Huddleston*, ___ U.S. ___, 74 L.Ed.2d 548, 553, n.5 (1983), namely, whether civil liability for aiding and abetting even exists under § 10(b) and Rule 10b-5. *Dirks* was a disciplinary proceeding which arose under § 15 of the Securities Exchange Act, 15 U.S.C. § 78o(b)(4)(E). Section 15 expressly authorizes the SEC to impose sanctions against broker-dealers who "willfully aided [or] abetted" violations of the federal securities law. The question in *Dirks* was whether sanctions could be imposed against a broker-dealer for aiding and abetting where the requisite elements of a primary cause of action had not been met. The Court concluded they could not.

disclose in connection with the purchase or sale of securities; (b) breach of this duty with the intent to deceive; (c) causing actual and identifiable damages.

The Court's primary focus in *Dirks* was on the duty requirement. The Court held that absent an underlying fiduciary duty to purchasers or sellers of securities, a broker-dealer who obtains material nonpublic information cannot be held secondarily liable for violating prohibitions against insider trading even if he uses the information for his own benefit or the benefit of his customers. 51 U.S.L.W. at 5126. A duty to disclose arises from an underlying fiduciary relationship and not merely from the possession f material nonpublic information.

The Court's insistence upon a fiduciary relationship to establish a cause of action for a secondary violation of securities law reaffirms the rule articulated in *Chiarella v. United States*, 445 U.S. 222 (1980), a case of primary responsibility. There, the Court ruled that absent such relationship, an individual who trades on inside information does not violate any provisions of securities law. Any other result would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties. . . ." *Chiarella, supra*, at 233. In *Chiarella*, in other words, the Court recognized that the disclosure duties imposed by § 10(b) and Rule 10b-5 do not apply across the board. They govern the conduct of fiduciaries; they do not govern the conduct of others. See *Walton v. Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980).

In *Dirks*, the Court ruled that the same principles apply to secondary violations of securities law. Absent a duty to disclose arising from the relationship between the parties to the transaction, a broker-dealer cannot be held liable for aiding and abetting violations of insider trading rules by failing to disclose material nonpublic information.

> "[T]here can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.' [*Chiarella, supra*], 445 U.S., at 232.
>
> * * *
>
> "We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.' 445 U.S., at 232-233, n.14." 51 U.S.L.W. at 5125, 5126.

In addition to breach of duty, the Court held that there must also be evidence that investors were in fact defrauded or deceived by the alleged misconduct: "[T]o constitute a violation of Rule 10b-5, there must be fraud." 51 U.S.L.W. at 5128, n.27. Moreover, the Court reiterated that scienter is an independent element of a Rule 10b-5 violation.

> "It is not enough that an insider's conduct results in harm to investors; rather, a violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors . . . .' *Ernst & Ernst v. Hochfelder*, [425 U.S. 185], 199 [1976]." 51 U.S.L.W. at 5127, n.23.

*Dirks* thus again establishes that in the case of both primary and secondary liability under § 10(b) and Rule 10b-5, the requisite elements of a cause of action are a duty to purchasers and sellers, a conscious intent to deceive, and deception in connection with a securities transaction. Because the broker-dealer in *Dirks* had no fiduciary duty to the purchasers of Equity funding stock, and because he had not come upon his nonpublic information in an illegal or improper way, this Court concluded he had no duty to disclose the information or refrain from trading. Absent such

a duty, the broker-dealer could not be liable for aiding and abetting violations of § 10(b) and Rule 10b-5.

The Court of Appeals decision in *Harmsen v. Smith* is in clear and direct conflict with *Dirks*. Where *Dirks* holds that duty is a sine qua non of both primary and secondary liability under § 10(b) and Rule 10b-5, the Court of Appeals has concluded that in the case of aider and abettor liability, "liability exists even when the secondary violator owes no duty to the plaintiffs." (Petition, App. at 21, n.10.) In the view of the Court of Appeals, Petitioner's insistence that liability cannot be imposed in the absence of a duty to purchasers "blurs the distinction between primary and secondary violations of section 10(b)." (Petition, App. at 20.)

The "distinction" the Court of Appeals draws between primary and secondary liability, however, is inconsistent with the principle enunciated in both *Chiarella* and *Dirks*, namely, that absent a duty to purchasers and sellers of securities, the conduct of third persons is simply not governed by § 10(b) and Rule 10b-5. Moreover, the "distinction" would create two separate classes of securities law violators: (1) primary violators, who must satisfy each element for civil liability mandated by this Court in its past decisions, including "a duty to disclose" (*Dirks*), scienter (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976)), and causation (*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154-155 (1972)); and (2) secondary violators, whose conduct by definition does not satisfy the above three elements (or else they would be guilty of a primary violation), but who nevertheless, solely by virtue of their relationship to a primary violator and their access to nonpublic information, share equal responsibility for his violation. The "distinction" the Court of Appeals recognizes for secondary violations thus has the effect of dismantling the Court's careful explication of the requisites of liability under § 10(b),

and imposes secondary liability without such meaningful limitations on persons who have only a marginal relationship to a securities violator, and no relationship to stock purchasers or sellers. The decision is premised on the view that, even in the absence of a fiduciary relationship, if an individual has sufficient control of material information, he has a general duty to disclose that information to all persons who might be relying on the integrity of the market. It thus gives unprecedented scope and effect, in the context of secondary liability, to the "fraud on the market" theory which, it seems, cannot in any event survive this Court's recent holdings under the securities laws. See Note, *Transamerica Mortgage Advisers, Inc. v. Lewis: Implications for Private Rights of Action For Damages Under Rule 10b-5*, 1982 University of Illinois Law Review 1045, 1073.

Had the Court of Appeals recognized that secondary liability under § 10(b) and Rule 10b-5 can only arise where the person who comes into possession of material nonpublic information is an "agent" of the corporation, a "fiduciary," or a " 'person in whom the [buyers of the securities] had placed their trust and confidence,' " 51 U.S.L.W. at 5125, it would have reached an entirely different result. It is undisputed that Petitioner fit none of the preceding categories; she was neither an officer, director or employee of USNB, she did not consult in USNB's financial affairs, and she was not involved in the preparation or dissemination of annual reports, proxy statements, or other documents issued by the bank. Under these circumstances, even assuming (contrary to the District Court's own observations) that Petitioner was somehow aware USNB was somehow misleading purchasers of its stock by alleged nondisclosure of information about her loan transactions,[3] the absence of *any*

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[3] In fact, the bank's annual reports at all relevant times generally, and in the 1972 and 1973 proxy statements specifically referred to Petitioner's business transactions with USNB. See Petition at 4.

relationship with the market purchasers conclusively establishes that Petitioner's supposed knowledge did not give rise to a duty to disclose the information, and could not afford a basis for holding her liable, either directly or secondarily, for violations of § 10(b) and Rule 10b-5.

Petitioner's situation is precisely analogous to the broker-dealer in *Dirks*, though many steps removed in terms of the degree of her knowledge as well as the materiality of any knowledge she may have had. In each case, the defendant allegedly had nonpublic information indicating that a corporation was withholding information from the public. In *Dirks*, the broker-dealer had information that Equity Funding's assets were vastly overstated (by approximately $22,000,000) as the result of fraudulent corporate practices. This information was clearly material in valuing Equity Funding's stock. In the present case, Petitioner was alleged to have knowledge that USNB was "withholding" information about three loans — two fully secured totalling $221,000, one technically unsecured (originally $500,000) — notwithstanding the actual disclosure of that information. (See Petition at p. 4.) Even assuming this information was material — an untenable proposition in light of testimony by Respondents' own expert that the loans could have had no impact on the value of USNB's stock[4] — *Dirks* unequivocally establishes that Petitioner would not have been liable under § 10(b) and Rule 10b-5 had she somehow been able to capitalize on this supposed "inside information" by purchasing or selling stock. "[T]here is no general duty to forgo market transactions 'based on material, nonpublic in-

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[4]It is undisputed that the bank never lost or was threatened with risk of loss on these loans or any other transaction with Petitioner. Indeed, the FDIC, the bank's receiver, reviewed and approved all such transactions.

formation.' 455 U.S., at 233." 51 U.S.L.W. at 5128, n.27.[5]

Since Petitioner would have been free to engage in market transactions without disclosing her nonpublic information, it follows that she cannot be liable to shareholders when she did not trade, even assuming she failed to make some extraordinary effort to publicly disclose. In short, absent a duty to purchasers of USNB stock, Petitioner's possession of "nonpublic market information" (*i.e.*, the same knowledge any person has about his own transactions) simply cannot give rise to liability under § 10(b) and Rule 10b-5. The Court of Appeals' conclusion that liability for aiding and abetting can exist based solely on knowledge that a corporation is violating securities law "even when the secondary violator owes no duty to the plaintiffs" is untenable in light of the contrary decision in *Dirks*, and raises the specter that all third parties who may have access to "nonpublic information" by virtue of business dealings with the stock issuer will henceforth be exposed to liability if they fail to monitor and expose possible violations of securities law by the stock issuer. (Petition, App. at 21, fn. 10.)

Equally serious is the Court of Appeals' disregard of the scienter requirement. In *Dirks*, the Court reaffirmed that § 10(b) and Rule 10b-5 are not violated absent intentional or willful conduct specifically designed to deceive or defraud investors. Yet the District Court stated there was a complete lack of evidence that Petitioner ever knew of USNB's alleged nondisclosure. (Petition at pp. 15-16.) Petitioner's "intentional or willful" conduct was therefore apparently satisfied merely by her knowledge of her own

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[5]The nonpublic information in *Dirks* was given to the broker-dealer with the specific intention that it would result in trading. 51 U.S.L.W. at 5129. (Blackmun, J., dissenting.) As a result of the information, Dirks' customers succeeded in liquidating more than $16 million in holdings. 51 U.S.L.W. at 5124.

transactions, and her failure to detect supposedly material omissions in USNB's annual reports. Petitioner, however, was neither an officer nor director of USNB, and was under no obligation to monitor its financial disclosures. Accordingly, her "failure" to uncover minor omissions in the bank's financial statements could not be characterized as "intentional or willful" conduct without stretching the scienter requirement of Rule 10b-5 beyond recognition.

*Dirks* lastly confirms that liability for secondary violations of § 10(b) and Rule 10b-5 cannot exist in the absence of fraudulent conduct which artificially affects the price of the stock. 51 U.S.L.W. at 5128, n. 27. This requirement was also completely discounted by the Court of Appeals. Respondents' own expert testified that Petitioner's transactions with USNB, disclosed or not, had no measurable impact on the value of its stock, *i.e.*, were not material. Any nondisclosure of information about her loans therefore clearly did not constitute "fraud" within the meaning of the statute, and cannot support a damage award equal to the *full* loss in value of *all* stock purchased since March 1, 1971 — an amount exceeding $6,200,000.[6]

To summarize, the Court of Appeals has concluded that Petitioner is secondarily liable for violations of § 10(b) and Rule 10b-5 because she was in possession of nonpublic information of the same kind held by anyone who deals with a securities issuer, namely information about her own transactions. She neither had any reason nor any duty to monitor the bank's disclosures in this or any other respect. The Court of Appeals decision is legally insupportable, gravely unjust, and should be reversed.

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[6]It bears repeating that had Petitioner actually traded on the basis of her supposed "inside information" instead of doing nothing, her liability would have been limited to disgorging any profits thus made.

**Conclusion.**

For the reasons set forth in the petition, in the accompanying reply brief and the instant supplemental brief, Petitioner respectfully prays that the Court grant review in order to resolve the important issues which the Court of Appeals' decision has raised.

Respectfully submitted,

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# Opposition

No. 82-1980

Supreme Court, FILED JUL 1983

# In the Supreme Court

OF THE

# United States

OCTOBER TERM, 1982

HELEN SMITH,
*Petitioner,*

vs.

FRED H. HARMSEN, et al.,
*Respondents.*

## BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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## QUESTIONS PRESENTED FOR REVIEW

1. Whether this Court should decide the question of aider/abettor liability under Section 10(b) of the Securities Exchange Act of 1934, in a case where such federal claims are not dispositive of the matter and where judgments for pendent state law claims will remain in effect regardless.

2. Whether the Ninth Circuit applied standards for determination of secondary liability under Section 10(b) which are entirely consistent with, and in some respects more stringent than, standards set out in prior case law.

3. Whether standing to sue is lost, retroactively, by failure to prevail at trial on the merits as to certain claims for certain periods of time.

4. Whether petitioner was afforded due process of law in all respects.

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No. 82-1980

# In the Supreme Court

OF THE

# United States

OCTOBER TERM, 1982

HELEN SMITH,
*Petitioner,*

VS.

FRED H. HARMSEN, et al.,
*Respondents.*

## BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Respondents, plaintiffs below, respectfully urge this Court to deny the petition of Helen Smith[1] for writ of certiorari. Review of this case is inappropriate in that the federal issues raised by petitioner are not dispositive of this case; pendent state claims, uniquely grounded in California law and not challenged herein, resulted in judgment against Helen Smith in excess of the federal claims. Moreover, nothing in the decision of the Ninth Circuit Court of Appeals is in conflict with other decisions of this Court or of other Courts of Appeals.

[1]Hereinafter "Helen" or "Mrs. Smith."

## I

## STATEMENT OF THE CASE

Petitioner Helen Smith is correct that this case does arise out of the failure of the United States National Bank. However, Mrs. Smith would have this Court believe that the only one involved in the failure of the bank was C. Arnholt Smith himself. In fact, it was overwhelmingly demonstrated at trial that Mr. Smith and a group of co-conspirators, including his wife Helen, were responsible for the losses suffered by plaintiffs in this case.

Helen attempts to paint a picture of herself as an innocent victim of technical federal securities laws. In fact, the jury found her liable for common law fraud, conspiracy to defraud, and conspiracy to abuse control, all state law claims, as well as violations of Rule 10b-5 as an aider and abettor, a control person and conspirator. The facts of this case bear directly upon the issues raised by petitioner in her claim that secondary liability was improperly imposed under Rule 10b-5. Moreover, petitioner's statement of the facts is incomplete and inadequate. Hence, a relatively extended discussion of the facts presented at trial will be set out.

### A. Background of United States National Bank

In the 1950's, USNB was a small regional bank in the San Diego area. During the 1970's, the bank grew to almost a billion dollars in deposits (EXH 119). C.A. Smith had control of the bank from 1933 until the bank was declared insolvent on October 18, 1973 (RT 2443-44, 2468). At the time of the failure, the bank had loans of between $150 and $200 million dollars which were determined to be uncollectible (RT 2235-37).

Every year the shareholders of USNB received a glowing annual report that told of substantial increases in the

bank's assets and earnings (Exhibit 119 contains all of the annual reports from 1960 to 1972). Even in difficult years for most banks, USNB continued to report extraordinary earnings to its shareholders.[2]

Each report contained statements that would lead the reasonable investor to believe he or she had reached eternal success. Indeed, the very first sentence of the 1972 Annual Report stated, "we have just completed the most *successful* year in our bank's history."[3] What was not told to the investors was how the success was being achieved or who was reaping the benefits of this success.

The 1972 Annual Report was sent out in late March of 1973 to all shareholders. Notwithstanding the glowing report, USNB was closed just seven months later by the Controller of the Currency. When the bank failed, among the loans outstanding were hundreds of thousands of dollars to the individual defendants or their business entities.

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[2]The 1966 Annual Report stated "USNB recorded the highest net operating earnings in its 53-year history during the past 12 months, even though 1966 was a difficult year for the banking industry." Unfortunately for the shareholders, dividends were always paid in stock (EXH 119, 1966 Report). The 1971 Annual Report stated that USNB enjoyed one of the most profitable years in its history while other banks varied in performance (EXH 119, 1971 Report).

[3]The report detailed for the shareholder the highlights of 1972. The resources reached the billion dollar mark, their deposits and *loans* grew to first place among San Diego based banks, they expanded to include an international office, they rose from 110th to 87th among the banks in the U.S., their capital account grew nearly 50%, they increased their resources 42 percent, deposits 41 percent, and loans 35 percent. Unfortunately, they neglected to tell the shareholders to whom the loans were made (EXH 119, 1972 Annual Report, page 2).

**B. How USNB Was Used by Defendants**

Using shell corporations, the defendants undertook an ambitious scheme of debt rolling, self-dealing and manipulation. The bank loaned millions to controlled entities whose sole purpose was to funnel these proceeds to other corporations where they were available for the defendants' purposes (EXH 191). Frequently, the funds were applied to existing obligations to USNB; the bank thus paid itself back with its own money. In other instances, loan money went into the defendants' own personal bank accounts.

The three major entities used by the defendants were Sovereign States Capital, Inc. (SSC), British Columbia Investment Corp. (BCIC), and Westgate California Corporation (WCC).

SSC was a Smith family owned entity. The company was owned by C. A. Smith, Jr. and his wife, Jean Smith, and perhaps some others (RT 3793-95). The company dealt primarily in real estate.

BCIC dealt in real estate as well. It was purchased in 1971 by defendant M. J. Coen with a loan. He borrowed the money from SSC, which borrowed millions from USNB (RT 4296-97; EXH 191). Smith continued to manage BCIC even though Coen owned it (RT 4299), and subsequently, BCIC went under the jurisdiction of the Bankruptcy Court (RT 4341).

WCC was a major conglomerate, consisting of tuna boats, an airline, hotels, real estate, and other ventures (EXH 150). During the relevant time periods, C. A. Smith was President and Chairman of the Board of WCC. In 1970, WCC and C. A. Smith owned the controlling interest in USNB (EXH 150-B). In 1972, it was discovered that

there were millions of dollars of loans allegedly made by USNB to Westgate California Corporation, but never put on the books of Westgate (RT 4214-4215). WCC also ended up in the Bankruptcy Court.

These entities, along with their numerous subsidiaries, were Smith controlled vehicles through which millions of dollars of loans passed. It was these three entities that Helen Smith used in her transactions.

### C. Helen Smith's Dealings with USNB

As her petition states, Helen is a wealthy and successful businesswoman. However, it became clear at trial that her assets came primarily from dealings with USNB, either directly or indirectly. Because of this, she now has assets in excess of $31 million, not including stock and personal assets (RT 9248-9264; 9285-9294; 9338-9352). Highlights of her transactions with USNB and related entities follow.

#### (1) Pueblo Lands Property

Helen Smith's first dealings with USNB were indirect and occurred in 1965, when she "invested" in real property jointly with C. A. Smith-owned entities. Although the various intermediate transactions were convoluted, the bottom line was simple: by 1973, Helen owned all the real property, the Smith-owned entities were in bankruptcy, and USNB was left with millions of dollars in uncollectible loans.

The transaction developed roughly as follows. In 1965, Helen Smith joined in a venture with Westgate California Realty (WCR), a wholly owned subsidiary of WCC. WCR purchased property in the Pueblo Lands area of San Diego

(RT 4208), using SSC as a nominee (RT 3758-60; EXH 413A). WCR had millions of dollars of fraudulent loans from USNB.

In 1971, WCR sold its interest in the land to British Columbia Investment Company (BCIC) for $500,000 (RT 4210; EXH 413B). Helen Smith herself signed the agreement and the deed to transfer one half to BCIC (RT 3761; EXH 413B). Subsequently, in 1973, the shares of BCIC were turned over to Mr. Smith (EXH 424, 425; RT 4344-4346).

Under the joint venture agreement, first WCR and later BCIC was to pay all taxes and keep the property up (EXH H.S. 41-43). In the spring of 1973, it became apparent that BCIC would be in default on millions of dollars of loans to USNB; BCIC's loans were classified since they did not have sufficient collateral (RT 3158). Loans to BCIC were brought to the attention of Mr. James Mulvaney, the President of USNB, by the national bank examiners (RT 3159). One of the loans was on the Pueblo Lands property and Mulvaney discussed it with Mr. Smith three or four months prior to the closing of the Bank (RT 3159-60).

Mr. Smith advised Mr. Mulvaney that Helen Smith had an involvement in the land, but that she would not give the bank a deed of trust as additional security. Mr. Smith personally discussed this with her (RT 3159-60). Mr. Mulvaney testified that had he known that Helen Smith was involved in the ownership of the land with BCIC, he would have considered that significant information relative to disclosure in the proxy statement (RT 3160).

On October 15, 1973, just *three days* prior to the bank being closed, Helen Smith was given a deed to the *entire*

*property,* on the pretext that BCIC had defaulted on its upkeep of the property (RT 3763-65; EXH 413B, C). Subsequently, BCIC went into bankruptcy, and the trustee sued Helen Smith and C. A. Smith for monies due to BCIC on the property. Helen and C. A. Smith settled the suit for $150,000 (RT 3774-77). Plaintiff's expert, Mr. David Yerke, testified that this property, as now owned by Helen Smith, has a fair market value in excess of $11,000,000 (RT 9292-93).

**(2) Muirlands Vista Property**

In 1966, shortly after Mrs. Smith's venture in the Pueblo Lands with WCR, she entered into an agreement directly with C. A. Smith or his son, to purchase valuable canyon property in San Diego (RT 3744-45). Above the canyon property was acreage which was purchased by SSC on October 9, 1967 (EXH 413F, G, H).

After Helen Hill married C. A. Smith in 1968, SSC sold the higher acreage to Westgate California Products (WCP) (EXH 413F, G, H). On December 30, 1970, the key lot, No. 35, was transferred to Helen Smith from WCP (EXH 413H; RT 3742-51). At the time WCP owed millions of dollars in loans to USNB.

Helen Smith received another piece of property located adjacent to the property from SSC. Mr. Smith ordered the transfer to Mrs. Smith. In the transfer request from Mr. Smith dated October 28, 1970, he requested that Lot 36 be transferred to "M.H. Alverez Hill—consideration $10.00" (EXH 430). It is curious that two years after their marriage, Mrs. Smith was still receiving property under the name of Hill. This no doubt played a part in the jury's verdict on fraud and conspiracy to defraud under state law.

Mr. Charles Kendrick testified the combined lots are now valued at $950,000 (RT 9254).

**(3) Rancho Sante Fe Property**

In 1967, Helen Smith entered into another joint venture with SSC to acquire property in Rancho Santa Fe (RT 3783-84). Helen Smith paid no money into the venture (RT 3786). The property was bought by SSC (RT 3786) and the deed was prepared by R. J. Sutter, the comptroller of WCC (RT 3787-88; EXH 413 D). On April 11, 1969, the property was transferred to Helen Smith (EXH 413E) on a deed prepared by D. C. Heffner (one of USNB's attorneys) and returned to Mr. Smith's office at USNB (RT 3790). The deed stated "No Tax Due", indicating that Helen paid no money for the transfer (RT 3791). The property was 12 acres with a large home on it. Mr. Kendrick testified the property is now worth $800,000 (RT 9253).

**(4) International Interior Designs**

Mrs. Smith also used her relationship with Mr. Smith to promote business with entities in which she was interested and which were borrowing millions from USNB.

In 1967, Helen Smith and Mr. Smith agreed that she would furnish decorating services for two new Westgate hotels. To do so, Helen formed International Interior Designs (IID). Helen's personal bookkeeper went on Westgate's payroll, except for a brief period in 1971, when she was put on IID's payroll because of an audit at Westgate. All overhead expenses were paid by Westgate, and Westgate paid for IID's personnel with its own payroll checks. Westgate paid for all Xerox costs of IID, while USNB paid for all office machinery.

Helen Smith billed Westgate $3,616,000 up through 1973. (RT 5499-5502) When the bank failed in 1973, it is estimated that Westgate or its subsidiaries had over $45 million in loans outstanding to USNB (Ex. 191).

SSC was also involved in Helen's decorating enterprise. On May 7, 1970, Westward Realty, a subsidiary of WCC, received a real estate loan of $1 million from USNB. The loan officer was C. Arnholt Smith. The $1 million was deposited in a bank account of SSC. On the *same day* SSC transferred $100,000 of the loan to IID, Helen Smith's interior decorator business. (EXH. 191-23). When asked where the $100,000 from SSC went, Helen Smith testified: "I don't know where it went." (RT 3914) On the same day IID books indicated that an *additional* sum of $50,000 was received from Westgate Plaza, a WCC subsidiary. In October, the books reflect that $100,000 was transferred to SSC and at the same time, $100,000 was received from Westgate Plaza (EXH. 412).

USNB was also directly involved with IID. Between 1971 and 1973 Helen sold the bank almost $1.2 million worth of goods and services. In 1973, the year that the bank examiners estimated that USNB had $50-$60 million in uncollectible loans, she sold the bank $794,000 in decorator good and services.[4]

---

[4]The parties stipulated to the sums in the Pretrial Order (CR 1036). Mr. James Mulvaney was the president of USNB at the time of the 1973 sales. He was asked the following questions:

> Q. Mr. Mulvaney, in the last hour and a half, you have testified about the dire straits that the bank was in in 1973. You have also testified that you were not aware that furniture purchases were being made during that year in the stipulated amount of some $740 thousand dollars. In your opinion, as

**(5) Loans from USNB**

In 1970, Helen's business, IID, made the first direct loan from USNB. The loan was for $500,000, and was secured by certificates of deposit. The bank ledger indicated that the loan was given at 0% interest (RT 2332-33). The following year, the same loan was renewed, again at 0% interest. (EXH 415). C.A. Smith's initials appeared on the note. When questioned about these entries, Mr. Francis Banffy, from the FDIC, stated: "Well, all I can say is that these entries up here are rather unusual in this loan." (RT 2334). Mr. Banffy had felt all the transactions were unusual and could not be explained (RT 2334-39). In 1973, the loan was renewed by USNB, but this time for the amount of $375,000 at an interest rate of 9¾%. By this time, the only collateral for the loan was one certificate of

---

the president of the bank, was the bank in a financial position to make those kinds of expenditures?

A. No, it was not.

Q. Did you ever see any of this furniture that was being ordered through Mrs. Smith?

A. I presume that some of the furniture was the furniture that went into furnishing the lower floors of the new building that was being built, an auxiliary building next to the U.S. National Bank Building, but that was a relatively *minor amount of furniture.*

Q. And, in your judgment, not $740 thousand dollars' worth?

A. I could not envision it being anything like that.

Q. Other than that, did you physically see where any of this furniture went?

A. No, I didn't.

Q. Do you know who authorized the acquisition of that furniture?

A. I do not. (RT 3179-3780)

deposit, in the amount of $100,000.[5] This C/D was paying to Helen Smith interest of 10½%—i.e., nearly one percent over what she had to pay for the "loan" from USNB. When asked how a loan could be extended to someone for less interest than was paid to that same individual on a C/D, Mr. Banffy answered, "I really don't know why the bank would want to pay more or could afford to pay more on a deposit than what it charges on loans." (RT 2345).

Helen Smith also arranged for USNB loans to her son, Joe Alvarez, for investments in real estate with Helen (RT 2737-38). As one example, Joe Alvarez refused to sign a statement concerning the purpose of a requested loan (RT 2738). Voler Viles, a bank officer, sent Mr. Smith an internal memo questioning the loan request (EXH 74). Mr. Smith responded by saying:

> "Dear Mr. Voler: Thank you for your note on Joe Alvarez. I talked with his mother about the matter, and she would appreciate your loaning him the money he requested and assured me she would take care of the obligation if any problem should develop.
>
> "The reason for this action is: If she loaned him the money, this would destroy the tax steps they have in mind in which Joe is purchasing a substantial amount of acreage from his mother in Borrego." (RT 2741)

As a result of the letter, Mr. Viles funded the loan (RT 2742).

---

[5]The records indicate that Helen prepaid interest (RT 2336, 3633); however, the sums paid did not equal to later mentioned interest rate.

Another example is a 1973 loan to Joe Alvarez for $150,000.[6] Voler Viles thought the request was unusual, and he made a memo of same.[7] None of these loans was disclosed to the investing public (EXH 119).

**D. Conclusion**

Petitioner Helen Smith's primary attack upon the Ninth Circuit's decision is that secondary liability under Rule 10b-5 can result in "liability to all the world" based upon "mere silence." The facts of this case, coupled with the extremely careful instructions given by the trial court, make it clear that far more than "mere silence" was involved. Helen Smith actively, intentionally and over a course of many years exploited her relationship with C. Arnholt Smith and the bank to make profits and "deals"

---

[6]It read in part:

> . . . please make a 60 day loan . . . for $150,000 to be secured by attached note. Joe's mother will be selling some stock to make a loan to him to repay this advance before maturity of loan. (EXH 78)

[7]Viles made the loan and made a confidential memo to his files on the loan. In part it read:

> "Upon further personal questioning directed to Mr. Alvarez, as to the true purpose of this second loan, he indicated that he personally was lending these funds to First California Company, Incorporated. Mr. Alvarez also requested that this purpose not be disclosed, and that collateral note, together with the corporate resolution to borrow, be retained in a confidential file to be locked in my office at all times." (EXH 79)

The credit file did not disclose the purpose of the loan (RT 2746). First California Company (FCC) was a market maker of USNB stock (RT 4289) as well as a borrower of money from USNB (EXH 169). Defendant M. J. Coen owned the controlling interest in FCC.

which would have been unavailable to any outsider. Helen Smith *stipulated* that none of these transactions was disclosed to shareholders prior to 1972. The Ninth Circuit quite correctly affirmed the judgment below.

## II

## REASONS REVIEW SHOULD BE DENIED

### A. This is an Inappropriate Case for Determination of the Aiding and Abetting Question

Petitioner notes that this Court has not specifically determined whether aiding and abetting liability is permissible under Section 10(b) and Rule 10b-5. *Herman and MacLean v. Huddleston,* ..... U.S. ....., 74 L.Ed.2d 548, 553, n.5 (1983). Petitioner further states: "In this case, the issue is squarely presented and *is dispositive.*" (Petition, p. 9).

However, the aiding and abetting issue in this case is *not* dispositive. Helen was found responsible for control person liability within the meaning of § 20(a) of the Securities Exchange Act of 1934; petitioner does not challenge this result. More importantly, even if the judgment against Helen for all federal violations were reversed, the judgment based upon pendent state law claims would stand. As determined by the Ninth Circuit, the federal claims are certainly "not frivolous," and pendent jurisdiction may be exercised even in the event of reversal. *Anderson v. Allstate Ins. Co.,* 630 F.2d 677 (9th Cir. 1980); *Traver v. Meshiry,* 627 F.2d 934 (9th Cir. 1980).

The pendent claims in this case—for fraud, conspiracy to defraud and conspiracy to abuse control pursuant to *Jones v. H.F. Ahmanson & Co.,* 1 Cal.3d 93 (1969)—are

premised solely on state law, are not attacked in this proceeding and resulted in monetary damages in excess of the damages pursuant to the federal claims. See Ninth Circuit opinion, Appendix to Petition, pp. 4-5.

Hence, determination of the federal issues in this case by this Court would not, as a practical matter, be dispositive of the result.

**B. The Ninth Circuit Did Not Expand Secondary Liability Beyond Prior Bounds**

Petitioner contends that the Ninth Circuit, and the trial court below, "expanded" the concept of secondary liability, extending it to persons only "remotely connected" with securities violations and to persons whose only transgression was silence or "mere inaction." As the statement of facts, supra, makes clear, Helen must be describing someone else's case: the evidence demonstrated Helen's knowing and active participation in numerous undisclosed transactions which enriched her at the Bank's—and the shareholder's—expense. In any event, however, the Ninth Circuit's formulation of the aiding and abetting standard was entirely consistent with—indeed, even more stringent than—prior case law in this Court, in the Ninth Circuit, and in other circuits.

**1. The Ninth Circuit Adopted a More Stringent Standard Than Earlier Cases.**

The Ninth Circuit decision in this case incorporates the aiding and abetting standards articulated in the Second Circuit case cited in *Huddleston's* note 5, *ITT, An International Investment Trust v. Cornfeld,* 619 F.2d 909, 922 (2d Cir. 1980):

> The elements of a cause of action for aiding and abetting under section 10(b) are: (1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong.
>
> (Appendix to Petition, p. 18; citations omitted)

Moreover, the Ninth Circuit found that Helen had *actual knowledge* of C. Arnholdt's primary violations and of her role in furthering them. The Court thus did not discuss or approve the use of any relaxed *scienter* standard, such as recklessness, as was done by the Second Circuit in *IIT v. Cornfeld.*

Equally as plain, the Ninth Circuit did not (as petitioner claims) hold that "silence" with "imputed" knowledge of the primary violation was sufficient to impose liability. Rather, the Court concluded that as a matter of fact the record reflected Helen's actual knowledge and substantial assistance:

> Although Helen testified that she never discussed USNB with C. Arnholt Smith, the record shows that Helen had numerous business dealings with USNB, including transactions in which she received loans at non-market terms and acquired real property at minimal cost. There is sufficient evidence from which the jury could conclude that she knew that potential investors were being deceived by C. Arnholt. Taken in the light most favorable to the plaintiffs, the evidence also adequately supports the jury's finding that Helen knowingly provided substantial assistance in the fraud.
>
> (Appendix to Petition, p. 19)

Thus, the standards which the Ninth Circuit applied to the facts in this case are, if anything, more stringent than prior case law.

**2. The Ninth Circuit Properly Determined Causation**

Petitioner further contends that the aiding and abetting standard adopted by the Ninth Circuit improperly failed to limit damages to "actual damages proximately caused by the violation." Petition, p. 16. In making this argument, petitioner deliberately ignores the distinction between primary and secondary violations, and merely *assumes* the impropriety of the latter. This circular logic must be rejected.

Helen Smith, as an aider/abettor, was liable for all damages proximately caused by the violations she committed. The violations she committed involved the maintenance and encouragement of a non-disclosure policy, such that thousands of shares of worthless USNB stock were purchased by uninformed investors.

As the Ninth Circuit correctly noted, the jury was carefully—and properly—instructed that any damages awarded must be "a proximate result of the alleged misleading statements or omissions, and the purchase of stock in reliance to [sic] that." Appendix, p. 23. Further, the time periods of each defendant's liability were actually printed on the damage verdict forms. For Helen, this period was March, 1971 through October, 1973. Hence, the jury was aware of and considered the "degree of [Helen's] secondary fault" and "the actual damages attributable to it." Petition, p. 17.

**C. Plaintiffs Below Had Standing to Sue Helen**

The sole basis for Helen's claim that plaintiffs lacked standing to sue is the argument that because the named plaintiffs purchased stock before the period of Helen's liability as established by the jury's verdict, in hindsight they had no standing to bring suit. This reasoning contradicts fundamental jurisdictional concepts.

The Ninth Circuit quite properly rejected this argument. See Appendix to Petition, pp. 16-17:

> These plaintiffs had standing to pursue the action in the first instance. Standing ordinarily does not depend upon the merits of a plaintiff's contentions; the requirement is based upon a separate determination that the plaintiffs have made "allegations of demonstrable, particularized injury." *Warth v. Seldin*, 422 U.S 490, 508, 95 S.Ct. 2197, 2210 (1975).

Moreover, of course, Helen's contention that no "alleged acts" of hers occurred prior to purchase of USNB stock by the named plaintiffs is simply erroneous. The Pueblo Lands property transaction, the Muirlands Vista transaction and the Rancho Santa Fe transactions (discussed supra) all had their genesis in years prior to 1968. That the jury decided to limit Helen's liability to the 1971-1973 period does not affect plaintiffs' standing based upon the allegations and the evidence in the case.

**D. Petitioner Was Not Denied Due Process of Law**

Petitioner's claim that due process was denied her borders on the frivolous. During the six years of pretrial in this case, Helen, through her counsel, explored every possible aspect of plaintiffs' case. Exhaustive discovery was

conducted; motions for summary judgment were made and argued; interlocutory appeals were taken. A Pretrial Order comprising some 63 pages was prepared and filed several months before trial began (CR 1036). The trial judge, in a then-novel ruling, even allowed defendants the opportunity to depose various absent class members.

Nor was it necessary that the trial court formally certify a subclass of purchasers for purposes of the 10(b) claims. In its Memorandum Decision and Order dated December 23, 1976 (CR 588), the trial court considered and rejected defendants' motion for class decertification based upon the Ninth Circuit's *Harmsen I* decision. Judge Enright's analysis was clear and through, and dealt with virtually every issue now raised by petitioner. His determination that the class as certified was proper and could adequately embrace the claims involving violations of § 10(b) was both an appropriate exercise of discretion and correct under the case law governing class actions in securities cases.

Nor did the trial court commit error in refusing to admit expert testimony on materiality. In the first place, this Court has repeatedly stated that materiality issues under Rule 10b-5 "are peculiarly ones for the trier of fact." *T.S.C. Industries v. Northway, Inc.*, 426 U.S. 438, 450 (1975) Given the "reasonable investor" standard for materiality, expert testimony on it is properly excluded under F.R.E. 702. Moreover, petitioner's expert limited the scope of his testimony solely to the materiality of Helen's own transactions, rather than the materiality of the primary violations in which she participated. Hence, the testimony was properly excluded.

Petitioner Helen Smith was fully and fairly on notice of all the claims against her, and had every opportunity to defend against them both before and during trial. She received due process of law.

## III

## CONCLUSION

The judgments against Helen Smith were fairly obtained after fair hearing. The standards applied by the Ninth Circuit in review were proper. Most importantly, the federal questions raised by petitioner are not dispositive of the case, since the pendent state law claims are unchallenged. It is respectfully requested that the petition be denied.

DATED: July 6, 1983

Respectfully submitted,

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FILED
AUG 5 1983

No. 82-1980

# In the Supreme Court

OF THE

## United States

OCTOBER TERM, 1982

HELEN SMITH,
*Petitioner,*

vs.

FRED H. HARMSEN, et al.,
*Respondents.*

**SUPPLEMENTAL BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT**

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Petitioner Helen Smith has filed a Supplemental Brief in support of her petition for certiorari. That brief inexplicably but repeatedly misstates the holdings of this Court's recent decision in *Dirks v. Securities & Exchange Commission.*[1] The *Dirks* discussion of aider/abettor liability is in fact entirely consistent with the analysis made by the Ninth Circuit in the instant case, and petitioner's claims to the contrary are at best disingenuous. This Supplemental Brief in Opposition is submitted pursuant to Rule 22.6.

Petitioner contends that "this court's decision in *Dirks* re-confirms that the requisites for primary liability under § 10(b) and Rule 10b-5 apply equally to causes of action

[1] . . U.S. . . , 51 U.S.L.W. 5123 (July 1, 1983)

premised on secondary violations of securities laws." (Supplemental Brief, p. 2) Petitioner claims that the *Dirks* case held that the same duty-to-disclose requirement necessary to primary insider trading liability under § 10(b) applies to secondary liability under that rule. Petitioner states that the *Dirks* case held as follows:

> Absent a duty to disclose arising from the relationship between the parties to the transaction, a broker-dealer cannot be held liable for aiding and abetting violations of insider trading rules by failing to disclose material nonpublic information.
>
> (Supplemental Brief, p. 3)

Based upon this premise, petitioner contends that the Ninth Circuit decision was in error.

However, petitioner's interpretation of *Dirks* is contrary to the plain language of that decision. In *Dirks,* this Court analyzed aiding/abetting liability under Rule 10b-5 in the context of tippee liability for trading on inside information. The Court's primary analysis centered on whether and when the "disclose-or-abstain" rule applied to an aiding/abetting (non-insider) tippee.

This Court made it quite clear that "the tippee's duty to disclose or abstain is *derivative from* that of the insider's duty." 51 U.S.L.W., at 5126. Therefore, "In determining whether a tippee is under an obligation to disclose or abstain, it is thus necessary to determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty . . . And absent a breach by the insider, there is no derivative [tippee] breach." 51 U.S.L.W., at 5127. The Court summarized as follows: "[W]e believe that there

must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain." 51 U.S.L.W., at 5128.

Thus, this Court stated plainly and repeatedly that the secondary liability of a tippee such as *Dirks* turns on the breach of a duty by the insider/tipper—the primary violator. The "relationship" which is important is the relationship between the shareholders or plaintiffs and the primary violator. *If* that relationship gives rise to a fiduciary duty to disclose, then the secondary violator "assumes" (at 5127) or "inherits" (at 5128) or "acquires" (at 5127, n.23) that duty as a derivative matter.

This is precisely the analysis made by the Ninth Circuit in the *Harmsen* case:

> Shannon and Toft also argue that aider and abettor liability cannot be applied to them because they were under no duty to disclose to USNB shareholders. *Chiarella v. United States*, 445 U.S. 222, 100 S. Ct. 1108 (1980). This contention blurs the distinction between primary and secondary violations of section 10(b). While C. Arnholt's duty to disclose arises from his position in the bank and his relationship to the shareholders, *Id.* at 227-228, 100 S.Ct. at 1114, the secondary violator's duty arises from "knowing assistance of or participation in a fraudulent scheme." *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973) (quoting *Anderson v. Francis I. duPont and Co.*, 291 F.Supp. 705, 709 (D.Minn. 1968)).
>
> (Petition, App. at 20-21)

This statement is identical in substance to this Court's standard in *Dirks:*

> Thus, a tippee assumes a fiduciary duty as the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.
>
> (51 U.S.L.W. at 5127)

It is respectfully submitted that the Ninth Circuit's decision below was consistent with this Court's holdings in *Dirks*. The petition for certiorari should be denied.

Dated: August 5, 1983

Respectfully submitted,

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U.S.
FILED
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### Introduction.

That the issues presented by Helen Smith's Petition for Writ of Certiorari require review is, we submit, clear without need of further argument. However, we take this occasion to present, consistent with Rule 22.5 of this Court's rules, a limited reply to Respondents' exceptionally inaccurate and ill-founded opposition to the petition, specifically regarding the mistaken suggestion that this Court should simply ignore the fundamental issues of federal securities law raised by this case.[1]

[1]Under the constraints of Rule 22.5 we do not address the utter falsity of Respondents' depiction of the record, as we had occasion to do in the briefs before the Court of Appeals, except to note that even Respondents' blatant distortions of fact (1) do not involve United States National Bank ("USNB"), let alone its shareholders, and (2) have nothing to do with any securities transaction. It is worth repeating that, to the extent Helen had any dealings with USNB, they were all reviewed and approved by the FDIC, USNB's receiver.

(footnote continued on following page)

**The Critically Important Federal Securities Issues Raised by the Petition Are Necessarily Dispositive of the Case Against Petitioner.**

In the absence of a definitive analysis by this Court of the viability of secondary liability under the federal securities laws, Respondents were able to present this case to the jury as an undifferentiated mass in which their federal securities law theories ("aiding and abetting," "conspiracy," "control person") were used interchangeably with each other and with the pendent state law claims. ("Whatever you want to call it, aiding and abetting, conspiracy, controlling person. When it all comes down to it, it's the acts of all of them that led to those . . . people losing [their] . . . investment. . . ." [RT 6608].)[2]

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In accordance with the above rule, we also do not discuss here the relevance of this Court's recent decision in *Dirks v. Securities and Exchange Commission*, ___ U.S. ___, 51 U.S.L.W. 5123 (July 1, 1983), which lends additional support to one of the principal contentions raised in Helen Smith's Petition for Writ of Certiorari, namely that there can be no secondary liability for aiding and abetting under the securities laws unless the requisite elements of a primary cause of action under § 10(b) and Rule 10b-5 have been met. Because *Dirks* is directly relevant, however, we are concurrently filing, in accordance with Rule 22.6 of this Court's rules, a supplemental brief which analyses the immediate import of that decision.

[2]Respondents' muddled approach to this case is illustrated by their persistent and fallacious equating of injury to the Bank (a derivative theory based upon a cause of action available, if at all, only to the FDIC as the Bank's receiver) with direct injury to the Bank's shareholders and this, in turn, with securities fraud. (Opposition at p. 14.) Similarly, Respondents dismiss as inconsequential the fact that it was demonstrated without controversy not after but *before* trial that all the named plaintiffs

Thus, starting with the premise that a viable federal cause of action exists for secondary violations of federal securities law, Respondents were able to present the jury with a maze of undefined accusations representing an indeterminable admixture of federal and state causes of action packaged together under a "whatever you want to call it" theory of liability.[3] Now, however, Respondents disingenuously suggest that their state law claims against Helen Smith are somehow independently viable regardless of the lack of merit of the federal securities claims employed indiscriminately against Helen, regardless of the absence of fundamental federal subject matter jurisdiction, and regardless of the basic denial of due process resulting from numerous procedural irregularities, including the lack of any properly identified class. In Respondents' view this is somehow an inappropriate context for the Court's consideration of the very important issues on which the case always turned. (Opposition at p. 13.)[4]

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acquired their stock before the earliest alleged wrongdoing of any kind by Helen and therefore there was no plaintiff who had standing to sue her on *any* count. Accordingly, the jury necessarily fixed Helen's liability in the abstract, *i.e.*, in the absence of any person purporting to have a cause of action against her. (Opposition at p. 17.) The Court of Appeals opinion itself reflects a similar confusion of terminology and theories, ostensibly deciding the case solely on an aiding and abetting theory (Petition, App. at 18), yet relying on principles imported from the common law of conspiracy to support that decision. (Petition at p. 19.)

[3]Cf. *Michigan v. Long*, ___ U.S. ___ 51 U.S.L.W. 5231, 5233-5234 (July 6, 1983), where the Court recently stated, in deciding whether to review a state court decision, that it will not deem state grounds "independent" where they are loosely interwoven with governing federal law.

[4]Similarly, Respondents suggest that the "controlling person" aspect of the "whatever you want to call it" theory of liability premised on section 20(a) of the Securities Exchange Act is somehow different and stands apart from the aiding and abetting theory relied upon by the Court of Appeals. (Opposition at p. 13.) It was, however, for good reason the Court of Appeals eschewed consideration of Section 20(a) in its

Plainly Respondents seek to obscure what Petitioner has repeatedly urged: whether it is phrased in terms of "aiding and abetting," "control person" or "conspiracy", liability under § 10(b) cannot be imposed where, as here, there is no duty to disclose, no intent to deceive, and no causal connection between the non-disclosure and any damage to the plaintiff; these requirements cannot be evaded or diluted by any sleight-of-hand, much less simply by switching labels for the theory of liability. (See Petition at pp. 11-18.) Respondents are understandably reluctant to confront these basic principles. Absent a valid basis for proceeding against Petitioner under the federal securities laws, the District Court could not have asserted pendent jurisdiction over any state law claims. E.g. *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187, 195-196 (3d Cir. 1976). See *Ayala v. United States*, 550 F.2d 1196, 1198-1201 and fn. 8 (9th Cir. 1977), *cert. dismissed* 435 U.S. 982 (1978) [absent an independent ground of federal jurisdiction over a party, "pendent party" jurisdiction cannot be asserted to hear state law claims against that party]; see also *Aldinger v. Howard*, 427 U.S. 1, 14-15 (1976). Even the Ninth Circuit's decision in this case recognizes the need for "an independent federal jurisdictional basis for the court to consider the pendent state claims. . . ." (Petition, App. at p. 12.) In short, the validity of the Court of Appeals' aider and abettor theory of liability is entirely dispositive of the action before this Court.

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opinion. Having used "controlling person" interchangeably with aiding and abetting, conspiracy, and other claims at trial, Respondents could suggest on appeal only Petitioner's marital relationship with C. Arnholt Smith as a basis for "controlling person" liability. This, of course, is in plain violation of this Court's repeated articulation of the prerequisites to § 10(b) liability and would make *any* purely personal relation with a securities law violator a basis for secondary liability. (See Petition at pp. 11-12.)

The substantive weakness of the aiding and abetting theory is of course compounded by the fundamental procedural defects in the proceedings, prominently including the class certification issue, which infected all of the claims against Helen. Thus, none of the named plaintiffs traded the Bank's stock contemporaneously with any alleged misconduct by Petitioner and none had any individual claim against her. No proper class or subclass was ever identified for purposes of § 10(b), the only federal basis for any action against Petitioner, and indeed, no class was ever framed in terms of any purported cause of action against her. The action as a whole lacked even the rudiments of procedural due process as regards Petitioner. As it was, she faced multi-million dollar liability without knowing the identity of or being able to confront even one of her phantom adversaries, and without knowing what it was she was supposed to defend against.

The unprecedented morass of ill-defined and misused terminology and accusations used by Respondents to ensnare Petitioner cannot divert attention from the pivotal importance of the aider and abetter theory of liability in this case. Federal courts are primarily forums for the resolution of federal claims, not state claims, and the question whether federal jurisdiction exists is therefore hardly a matter of secondary importance. Moreover, if the question whether aiding and abetting liability is permissible under § 10(b) and Rule 10b-5 is not dispositive here, it is hard to imagine a case where it ever would be. With the doors of the federal courts thrown wide open to the assertion of any and all claims for "secondary liability" under the federal securities laws, federal courts become the preferred forum for litigating pendent state claims as well, and plaintiffs will always be in a position to assert, as Respondents did at trial, that such a mass of allegations warrants the imposition of liability under some theory "whatever you want to call it"

under federal or state law. The key issue — the viability and requisites of the federal claim — would become only a nominal and utterly dispensable consideration, just as standing does under the Court of Appeals' decision. In this case, these issues were fully preserved and for the first time squarely (if erroneously) addressed by the Court of Appeals. For these reasons, this case is precisely *the* most appropriate vehicle in which to consider and reject the Court of Appeals' explicit determination of critical federal securities law issues necessary to its decision.

**Conclusion.**

For the reasons set forth in the petition, Petitioner's supplemental brief, and the instant reply brief, Petitioner respectfully prays that the Court grant review in order to resolve the important and dispositive securities law and due process issues which the Court of Appeals' decision has raised.

Respectfully submitted,

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